85-1196

No. ——

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

CITY OF CHARLOTTESVILLE, VIRGINIA,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
COLUMBIA GAS TRANSMISSION CORPORATION,
COLUMBIA GULF TRANSMISSION COMPANY,
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA,
Respondents.

APPENDIX TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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TABLE OF CONTENTS TO APPENDIX

	Page
1. Opinion of the United States Court of Appeals for the District of Columbia Circuit in *City of Charlottesville v. FERC*, D.C. Cir. No. 83-2059 (October 18, 1985), as reported at 774 F.2d 1205 (D.C. Cir. 1985)	1a
2. Opinion 173 of the Federal Energy Regulatory Commission, 23 FERC (CCH) ¶ 61,396 (1983)	38a
3. Notice of Denial of Rehearing of Opinion No. 173, 24 FERC (CCH) ¶ 61,258	99a
4. October 18, 1985 Notice of Judgment in No. 83-2059	100a
5. January 13, 1986 Order Denying Suggestion for Rehearing *En Banc* in No. 83-2059	101a

APPENDIX

UNITED STATES COURT OF APPEALS
DISTRICT OF COLUMBIA CIRCUIT

No. 83-2059

CITY OF CHARLOTTESVILLE, VIRGINIA,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

Argued Sept. 28, 1984

Decided Oct. 18, 1985

Petition for Review of an Order of the
Federal Energy Regulatory Commission

William T. Miller, Washington, D.C., with whom Susan N. Kelly, Washington, D.C., was on brief, for petitioner.

Andrea Wolfman, Atty., F.E.R.C., Washington, D.C., with whom Stephen R. Melton, Acting Gen. Counsel, and Barbara J. Weller, Deputy Sol., F.E.R.C., Washington, D.C., were on brief, for respondent. Robert F. Shapiro, Atty., F.E.R.C., Washington, D.C., also entered an appearance.

John H. Pickering, Washington, D.C., with whom Giles D.H. Snyder, Charleston, W.Va., Timothy N. Black, and James E. Coleman, Jr., Washington, D.C., were on brief,

for intervenors Columbia Gas Transmission Corp., and Columbia Gulf Transmission Co.

Dale A. Wright, James T. McManus, and John H. Cheatham, III, Washington, D.C., were on brief, for intervenor Interstate Natural Gas Ass'n of America.

Before BORK and SCALIA, Circuit Judges, and GASCH,* District Judge for the United States District Court for the District of Columbia.

Opinion for the Court filed by Circuit Judge SCALIA.

SCALIA, Circuit Judge:

Each year since 1947, Columbia Gas System, Inc. ("Columbia System"), a public utility holding company, has filed a consolidated federal income tax return on behalf of itself and its subsidiaries, pursuant to the Internal Revenue Code of 1954, 26 U.S.C. § 1501 (1982). The subsidiaries include two interstate natural gas pipelines subject to the jurisdiction of the Federal Energy Regulatory Commission ("FERC"): Columbia Gas Transmission Corp. ("Columbia Gas") and Columbia Gulf Transmission Co. ("Columbia Gulf"). For the second time, *see City of Charlottesville, Va. v. FERC*, 661 F.2d 945 (D.C.Cir.1981) (*"Charlottesville I"*), the City of Charlottesville, Virginia, a customer of Columbia Gas, much of whose gas is transported by Columbia Gulf, petitions this court for review of the Commission's decision to use a "stand-alone" methodology to determine the tax alowances included in the costs of services, and hence the rates, of the two pipelines. Charlottesville contends that FERC must require the pipelines to share with their ratepayers the tax savings resulting from the use of tax losses of the system's gas supply subsidiaries in the consolidated return; and that the Commission's methodology fails to accord to ratepayers, as the Commission agrees it should, a proportionate share of the tax savings result-

* Sitting by designation pursuant to 28 U.S.C. § 292(a) (1982).

ing from the parent company's interest expense deduction from consolidated income.

I

The Natural Gas Act requires the Commission to insure that the rates of pipelines subject to its jurisdiction are "just and reasonable." 15 U.S.C. § 717c(a) (1982). Under cost-of-service ratemaking principles, this means rates yielding sufficient revenue to cover all proper costs, including federal income taxes, plus a specified return on invested capital. *See Public Service Co. of New Mexico v. FERC*, 653 F.2d 681, 683 (D.C.Cir.1981). When a utility is an unaffiliated company and files its own tax return, calculation of the appropriate tax allowance is in principle no different from determination of any other operating or maintenance expense, although differences in the timing of recognition of expenses for tax and ratemaking purposes often complicate the calculation. *See Public Systems v. FERC*, 709 F.2d 73, 75 (D.C. Cir.1983). When the utility is part of a consolidated group, however, only the group files a return and pays taxes, computed on the cumulated revenues and deductions of all affiliates and the parent. The Commission must nonetheless determine separate tax allowances for the affiliated utilities it regulates, which it has done over the years by using one or the other of two basic methodologies.

The more venerable, the so-called "flow-through" methodology, immediately reflects in rates all the tax savings resulting from use of a consolidated return. These savings are twofold. First, unless all affiliates with tax losses would be able to take advantage of carry-forward or carry-back provisions of the tax code allowing them to use their losses to reduce their own future taxes or collect refunds on past payments, *see* 26 U.S.C. § 172, aggregating them in a consolidated return with income-producing affiliates results in less taxable income for the group than there would be if each affiliate filed separately. Second, even if each affiliate could make use of its losses

in future periods, the group gains the time value of money by using the losses immediately. Although the group in fact pays taxes on its net aggregate income at the statutorily prescribed rate, it can be thought of as, in a sense, paying at a "lower" tax rate than it would if all of its affiliates filed separate returns, because of the lower total taxable income that results from consolidation. A flow-through methodology applies this hypothetical lower (or "effective") tax rate to the earnings of the (presumably) profitable utilities to yield the tax allowances. For instance, the form of flow-through recommended in this case by Charlottesville would derive an effective tax rate by determining the ratio of each pipeline's taxable income to the total taxable income of all affiliates, multiply this fraction by the group's consolidated tax liability, and divide this figure by the pipeline's taxable income.

The second basic methodology, used by the Commission only in recent years, seeks, for tax purposes, to segregate the affiliated utility from the rest of the consolidated group. With minor adjustments not pertinent here, the calculation proceeds as follows: The utility's tax base is determined by identifying the taxable income and deductions of the consolidated group specifically attributable to the utility's jurisdictional activities. The statutory tax rate (which, in the case of regulated utilities, will almost always be the maximum rate) is then applied to the tax base to yield the stand-alone tax allowance. Usually, as in the present case, a stand-alone calculation will produce a higher tax allowance than a flow-through methodology, because the tax base, and hence the effective tax rate, is not reduced by the tax losses of other affiliates.

Until 1972, the Commission (then the Federal Power Commission) generally required regulated companies to flow through consolidated tax savings to their ratepayers. In *United Gas Pipe Line Co. v. FPC*, 357 F.2d 230 (5th Cir.1966), and *Cities Service Gas Co. v. FPC*, 337 F.2d 97 (10th Cir.1964), two circuit courts held that it was

beyond the Comission's statutory authority to consider nonjurisdictional losses of members of a consolidated group when determining the proper tax allowance for jurisdictional companies. The Supreme Court reversed these decisions, holding that "in the proper circumstances the Commission has the power to reduce cost of service, and hence rates, based on the application of nonjurisdictional losses to jurisdictional income." *FPC v. United Gas Pipe Line Co.*, 386 U.S. 237, 245, 87 S.Ct. 1003, 1008, 18 L.Ed.2d 18 (1967). The Court thus authorized, though it did not require, the general use of flow-through methodology to calculate tax allowances.

Five years later, perceiving a need to encourage gas exploration, the Commission decided to switch to stand-alone methodology, announcing that

> if a case were before us where an affiliated, regulated or non-regulated, producer of oil or gas showed a tax loss, and this loss company were joined in a consolidated return with a pipeline, the *United* or *Cities Service* cases, in our opinion, would no longer be persuasive authority, for to reduce the rates of a regulated pipeline because of such affiliated exploration and development activities would be discouraging to the very enterprise we now want to encourage.

Florida Gas Transmission Co., 47 F.P.C. 341, 362 (1972). More generally, the Commission felt that "as the pipeline business develops with numerous subsidiaries we should avoid regulating one company on the basis of the activities of others in the affiliated group." *Id.* at 363. It concluded that "a utility should be regulated on the basis of its being an independent entity; that is a utility should be considered as nearly as possible on its own merits and not on those of its affiliates." *Id.*

The Commission further explained the stand-alone methodology in *Southern California Edison Co.*, 59 F.P.C.

2167 (1977). Edison, an electric rather than a gas utility, and a member of a consolidated group, had calculated its tax allowance on a stand-alone basis, which practice a Commission administrative law judge had upheld on the strength of the "incentive" rationale of *Florida Gas*. The Commission acknowledged that the *Florida Gas* policy of encouraging exploration was based on the special circumstances of the gas industry, but nonetheless found the stand-alone policy applicable to Edison (and all other utilities) because "as an alternative ground for decision in [*Florida Gas*] . . ., the Commission determined that utilities should henceforth be considered as separate entities for the ratemaking purpose of determining their costs of providing jurisdictional service." 59 F.P.C. at 2173. This is to be done by considering the *source* of the consolidated tax savings, which normally

> will be attributable to business activities which are totally unrelated to the providing of electric utility service . . . . Certainly, if this were the case, it would be difficult to justify the appropriation of any tax savings attributable to [such activities] . . . by the jurisdictional consumers *when these same consumers did not pay the expenses which created the deductions for tax purposes.*

Id. at 2174 (emphasis added). The standard set out in the emphasized passage is often referred to as the "benefits/burdens" test: the benefits of consolidated tax savings are given to ratepayers (by reducing the jurisdictional affiliate's tax allowance) if they bore the burden of paying the deductible expenses that generated the savings.

The present chapter in the ongoing stand-alone saga arose out of February 28, 1973 rate filings by the two Columbia pipelines. Previously the pipelines had, in accordance with the Commission policy affirmed by the Supreme Court in *United*, claimed tax allowances calculated on the basis of the consolidated tax liability of the affiliated group. These were consistently less than they

would have been had each pipeline filed a separate return, since every year a number of their sister companies and their parent generated considerable tax losses. The sister companies' losses were almost entirely the result of gas exploration and development activities, which in the early stages often generate substantial tax deductions and little income. The parent, Columbia Gas System, Inc., always shows a year-end tax loss on a separate return basis,[1] because the interest income it receives from its subsidiaries (plus a small amount of interest earned on short-term outside investments) is always less than the interest it pays to outside creditors and claims as a deduction, *see* 26 U.S.C. § 163(a). The gap between interest income and interest expense is attributable in small measure to the fact that the parent, which does all of the outside borrowing for the system, lends capital to its subsidiaries at a slightly lower interest rate than it pays,[2] but principally to the fact that the parent's capital structure is more heavily debt-oriented than are the capital structures that it maintains for its subsidiaries.

In the Columbia pipelines' 1973 rate case, their first rate case after *Florida Gas*, the pipelines ceased reflecting consolidated tax savings in their proposed tax allowances. Since settlement was reached on all other issues, the propriety of that tax treatment was reserved for separate hearing in the rate proceeding involving the pipelines'

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[1] It is, of course, consistently profitable by every measure except the Internal Revenue Code's because of the substantial dividends it receives from its subsidiaries, which are fully deductible, *see* 26 U.S.C. § 243(a)(3), (b), and indeed need not even be reported on its consolidated return. *See* 26 C.F.R. § 1.1502-14(a) (1985).

[2] To be exact, when the parent lends capital to a subsidiary, it does so at the rate at which it borrowed the money from outside creditors *rounded down to the nearest one-tenth of one percent.* To use an example given by the Commission, if the parent issues 30-year bonds to the public paying a coupon rate of 9.83 percent, it will lend to its subsidiaries for the same term at 9.80 percent.

subsequent May 30, 1975 rate filings. *See Columbia Gas Transmission Corp.*, 54 F.P.C. 2578, 2579-80 (1975).[3] Following this hearing, the administrative law judge held that the stand-alone policy was "fatally defective as applied," *Columbia Gulf Transmission Co.*, 8 F.E.R.C. (CCH) ¶ 63,009, at 65,145 (July 7, 1977), and that "the tax savings resulting from filing a consolidated return have to be reflected in the respective costs of service of the Columbia pipelines." *Id.* The ALJ found that because the latest nationwide rates for gas producers included a stand-alone tax allowance to encourage exploration and development, the inclusion of a second-level stand-alone allowance for pipelines would be double-counting. He further found that much of the money collected as tax allowances by the Columbia pipelines in 1973-75 went to "general corporate purposes" rather than to exploration and development affiliates as contemplated by the *Florida* Gas rationale, and that even when exploration took place, there was no assurance that the Columbia pipelines' ratepayers would benefit from it. He strongly urged FERC to reassess generally the policy of *Florida Gas*. *Id.* at 65,148, 65,150.

In Opinion No. 47, reversing the ALJ's decision, FERC reaffirmed *Florida Gas*, holding that "[n]othing brought to our attention invalidates its reasoning." *Columbia Gulf Transmission Co.*, 8 F.E.R.C. (CCH) ¶ 61,002, at 61,009 (July 2, 1979) (footnote omitted). The Commission emphasized that the need to encourage gas exploration had not abated since 1972, and emphatically disagreed with the ALJ's assessment of the character and effect of the 1976 nationwide rate orders. *Id.* at 61,007-08. It concluded that "[t]o require Columbia to pay its

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[3] Settlement was reached in the 1975 rate proceeding on most issues, including the proper rate of return for the relevant period and the use of the parent's capital structure and interest costs in calculating the rate of return. *See Columbia Gulf Transmission Co.*, 56 F.P.C. 1651 (1976).

pipeline customers the tax savings from losses incurred in the search for gas supplies will operate as a disincentive to continued gas supply development activities by pipelines and other regulated utilities." *Id.* at 61,008. With respect to losses generated by the parent company's method of financing its subsidiaries, the Commission noted that the pipelines' allowable rates of return were calculated using the capital structure and interest costs of the parent because the capital structures and interest costs of the wholly-owned pipelines themselves, which issue no securities to the public, are determined solely by the parent rather than the marketplace. In such cases, the Commission said, it must either use the capital structure and interest costs of the parent or construct a hypothetical structure and costs that attempt to approximate what market judgments would produce.[4] In this case, all parties agreed that the former was preferable.[5] In calculating the pipelines' tax allowances pursuant to the methodology described earlier, *see supra* page 3, the Commission allowed as deductions interest expenses based, as the pipelines' rates were, upon the parent's structure and costs. FERC maintained that this procedure already gave "the pipelines' customers . . . a proportionate share of the tax deductions related to Columbia's interest costs," and that the approach adopted by the ALJ of applying in addition the parent's effective tax rate "would give pipeline customers the benefits of the same tax deductions

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[4] It is obvious why a difference in interest costs, *i.e.*, the interest paid on long-term debt (bonds), affects allowable rate of return. The influence of the capital structure upon the allowable rate is just as great, though more indirect. Equity capital must be permitted a higher rate of return than debt capital, and so the composite rate for all capital (equity plus debt) rises as the proportion of equity capital increases.

[5] The Commission has recently rejected the latter alternative as a permissible ratemaking methodology. *See Tennessee Gas Pipeline Co.*, 32 F.E.R.C. (CCH) ¶ 61,086 (July 22, 1985); *Arkansas-Louisiana Gas Co.*, 31 F.E.R.C. (CCH) ¶ 61,318 (June 18, 1985).

twice." 8 F.E.R.C. at 61,008 (footnote omitted). Accordingly, over the dissent of two commissioners, *id.* at 61,011-17, FERC held the tax allowances claimed by the pipelines just and reasonable. *Id.* at 61,009.

Charlottesville's petition for rehearing was denied by the Commission in Opinion No. 47-A, *Columbia Gulf Transmission Co.*, 9 F.E.R.C. (CCH) ¶ 61,355 (Dec. 20, 1979), which generally restated the reasoning of Opinion No. 47. The Commission added, however, that it would depart from its view that pipelines with loss affiliates need not charge lower rates than unaffiliated pipelines "when the customers of a regulated entity contributed to the expenses which created the loss deductions of the affiliate in the consolidated tax group." *Id.* at 61,746 (citing *Southern California Edison*). The Commission found this exception inapplicable. *Id.* at 61,746-47.

Charlottesville petitioned this court for review of Opinions Nos. 47 and 47-A. The panel upheld an aspect of the decisions not at issue here, *see Charlottesville I*, 661 F.2d at 952, but remanded the question of treatment of the above described tax losses to the Commission. While finding that the Commission had the statutory authority to employ the stand-alone method, *id.* at 953, 954, the panel majority did not believe that the Commission had provided adequate evidentiary support for its basic premise that stand-alone tax allowances would in this case encourage exploration and development. *Id.; id.* at 954-55 (Wald, J. concurring).[6] With respect to the tax losses of the parent company, the court unanimously found the record "incomplete on the relationship between the tax costs and capital costs included in the rate base." *Id.* at 952.

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[6] Judge MacKinnon would have affirmed the Commission's analysis of the incentive effects of stand-alone tax allowances. *Charlottesville I*, 661 F.2d at 955-59 (MacKinnon, J., dissenting in part).

On remand, in Opinion No. 173, the Commission reiterated its adherence to the stand-alone method, but for reasons different from those in Opinion No. 47. FERC said:

> In reviewing this record we have reconsidered the policy question from the ground up. Though we reach the same result on that question as did the Commission in Opinion No. 47 and Opinion No. 47-A, we do so for considerably different reasons. Specifically, we place no reliance on what has come to be called the "incentive rationale" that the Commission relied on in those Opinions. We do so because the policy the Commission applied is broader and more fundamental than one needed to encourage gas supplies. The policy involves a basic decision about the proper way to set cost-based rates. As such, the policy applies not only when a pipeline joins with an exploration affiliate in filing a consolidated return but also when any jurisdictional company, be it a pipeline or an electric utility, joins with other businesses in filing a consolidated return.

Columbia Gulf Transmission Co., 23 F.E.R.C. (CCH) ¶ 61,396, at 61,870 n. 8 (June 22, 1983). In place of the incentive rationale of *Florida Gas*, the Commission relied on the benefits/burdens rationale set forth in *Southern California Edison*, which it described in Opinion No. 173 as the principle of "cost responsibility or cost incurrence," 23 F.E.R.C. at 61,850, *i.e.*, the allocation of the consolidated company's costs (*all* costs and not merely taxes) to the regulated subsidiary "on the basis of a causal link," *id.*, between those costs and the services the subsidiary provides to its ratepayers. In the case of taxes, this allocation is to be made by, first, estimating the taxable income the company is expected to receive from providing jurisdictional service (a relatively easy task) and, second, identifying the deductions of the group fairly traceable to the provision of service. This latter process is conducted as follows:

> Because deductions are given for expenses incurred in producing income, the necessary causal link between the ratepayers and the deductions is the expenses the company incurs in providing service. Accordingly, the proper way to allocate deductions is to match the deductions with the expenses included in the cost of service. Thus, when an expense is included in the cost of service, the corresponding tax deduction is also allocated to the ratepayers. In this way any tax reducing benefits, or savings, the company realizes in providing the service are recognized in calculating the tax allowance for the benefit of the ratepayers.
>
> The corollary to this is that when an expense is not included in the cost of service (because the company did not incur that expense in providing service), the deduction created by that expense is not allocated to the ratepayers. To do otherwise would result in the tax savings the company realizes from expenses incurred in providing services to other groups and periods or for its own benefit being used to reduce rates for a particular group of ratepayers. The tax allowance would then be lower or higher than is warranted by the profit each group provides the company. Since the amount of profit to be provided is the measure of the tax cost the company will incur in providing service, none of the rates for the groups would be cost-justified. Subsidization would inevitably result. One group would bear the burden, but another group would gain the benefit.

Id. at 61,851.

Applying this rationale to the tax losses generated by the activities of the exploration and development affiliates, the Commission found that there was an insufficient connection between the burdens imposed on the pipelines' ratepayers and the tax benefits enjoyed by the consolidated group to warrant allocating a share of the savings to the ratepayers. *Id.* at 61,861-63. With respect to the

interest-expense losses of the parent, the Commission again found, as it had in Opinion No. 47, that by using the parent's capital structure and interest costs to determine the appropriate interest deductions in the pipelines' tax allowances, the stand-alone method did in fact flow through a proportionate share of these consolidated tax savings, and to flow them through again (*e.g.*, by use of an effective tax rate) would be double counting. *Id.* at 61,866-68.

FERC denied without comment Charlottesville's petition for rehearing, *Columbia Gulf Transmission Co.*, 24 F.E.R.C. (CCH) ¶ 61,258 (Aug. 22, 1983), and Charlottesville once again petitioned for review in this court pursuant to 15 U.S.C. § 717r(b) (1982).

II

Charlottesville raises several threshold procedural objections. It first contends that the Commission improperly prejudged the outcome of the remand proceeding, citing the language used by the Commission when it remanded the case to the ALJ following *Charlottesville I:*

> The other remanded questions involve our general policy on consolidated taxes. Our policy in the past has been that "a utility should be regulated on the basis of its being an independent entity; that is a utility should be considered as nearly as possible on its own merits and not on those of its affiliates." *Our present view remains the same, based on our conviction about the proper way to set rates for a regulated company. Evidence of a particular company's circumstances is not needed to make this policy determination.* In light of the remand, however, the parties should address the validity of our "stand alone" policy in their presentations to the law judge.

Columbia Gulf Transmission Co., 20 F.E.R.C. ¶ 61,036, at 61,069 (July 8, 1982) (quoting *Florida Gas*, 47 F.P.C.

at 363). In order to establish improper prejudgment of a case, it must appear to " 'a distinterested observer . . . that [the agency] has in some measure adjudged the facts as well as the law of a particular case in advance of hearing it.' " *Cinderella Career and Finishing Schools, Inc. v. FTC*, 425 F.2d 583, 591 (D.C.Cir.1970) (quoting *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 469 (2d Cir.), *cert. denied*, 361 U.S. 896, 80 S.Ct. 200, 4 L.Ed.2d 152 (1959)). The above-quoted passage from the Commission's order may establish that FERC "prejudged" the law as to whether the stand-alone policy is consistent with its statutory mandate (on which point it had in any event been *upheld* in *Charlottesville I*, *see* 661 F.2d at 953, 954), and as to whether the nature of that policy requires case-by-case demonstration of incentive effect on exploration and development. But preconceptions regarding the law no more invalidate agency action than they do the action of a court. *See FTC v. Cement Institute*, 333 U.S. 683, 700-03, 68 S.Ct. 793, 803-04, 92 L.Ed. 1010 (1948). The "facts" that the Commission would have had to prejudge for Charlottesville to prevail on the present argument are whether the stand-alone policy, assuming its nature and validity, sustains the rate order—*i.e.*, whether the Columbia pipelines' ratepayers could satisfy the benefits/burdens test. There is no indication of any such prejudgment in this record.

Charlottesville further contends that FERC exceeded the scope of the remand of *Charlottesville I* by basing its decision in Opinion No. 173 on a different rationale (*i.e.*, the benefits/burdens principle) than that advanced in Opinions Nos. 47 and 47-A. *See* 23 F.E.R.C. at 61,870 n.8. Charlottesville argues that the remand in *Charlottesville I* was for the purpose of allowing the Commission to develop an adequate record to support the incentive rationale, "not to permit the Commission to seize upon whatever new theories had struck its fancy since the issuance of Opinion Nos. 47 and 47-A, as if it were dining

at an evidentiary smorgasbord." Brief for Petitioners at 41. We do not agree that the mandate of *Charlottesville I* was so narrow. The court found the record on the incentive rationale insufficient to support the Commission's order, and remanded the case "for proceedings not inconsistent with this Opinion." 661 F.2d at 954. As a general proposition, "[an] administrative tribunal is free on remand to reach the same result on different grounds." *Chicago and North Western Transportation Co. v. United States*, 574 F.2d 926, 930 n. 5 (7thCir.1978). *See SEC v. Chenery Corp.*, 332 U.S. 194, 200-01, 67 S. Ct. 1575, 1579, 91 L.Ed. 1995 (1947). Nothing in the mandate of *Charlottesville I* forbids application of this rule, and the Commission was therefore free to reaffirm the stand-alone policy on different grounds.

Charlottesville's last procedural contention—that the benefits/burdens principle relied on in Opinion No. 173 was tacitly rejected by the decision in *Charlottesville I* and thus cannot support the Commission's action on remand—is too insubstantial to bear discussion. *See* 661 F.2d at 949, 951.

III

Charlottesville contends that the stand-alone methodology is *per se* unlawful because the Commission can properly consider only "actual taxes paid." It might suffice to say that *Charlottesville I* explicitly found the stand-alone policy consistent with the Commission's mandate, *see* 661 F.2d at 953-54, and explicitly rejected the "actual taxes paid" objection, *see id.* at 952 & n. 38. Since discussion of the objection in that earlier appeal was brief, however, and since the "actual taxes paid" concept is relevant not only to Charlottesville's attack upon stand-alone in principle, but to one of its subsequent challenges to the Commission's manner of applying stand-alone in the present case, it warrants some extended discussion.

The earliest case we have found applying the "actual taxes paid" principle by name is *El Paso Natural Gas Co. v. FPC*, 281 F.2d 567 (5th Cir.1960), *cert. denied*, 366 U.S. 912, 81 S.Ct. 1901, 6 L.Ed.2d 1247 (1961), which ordered the Commission to require an integrated gas company to flow through to ratepayers tax savings resulting from depletion allowances, *see* 26 U.S.C. §§ 611-613A, and the deduction of intangible drilling expenses, *see* 26 U.S.C. § 263(c). The Fifth Circuit held:

> We think, in short, that there is no statutory authority for the Commission to treat actual savings in taxes to which natural gas companies are entitled any differently than savings in any other cost of service. It is the obligation of all regulated public utilities to operate with all reasonable economies. This applies to tax savings as well as economies of management. The net result of this, of course, is that such savings as are effected are passed on to the consuming public. This we consider to be the natural and necessary consequence of rate regulation.

281 F.2d at 573. The court did not, however, require the flow-through of tax benefits resulting from accelerated depreciation, *see* 26 U.S.C. § 167, allowing the utility instead to "normalize" those deductions [7] on the ground that they resulted only in a tax deferral rather than a

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[7] As a number of opinions of this court have discussed, normalization involves computing taxes for ratemaking purposes as though a utility takes depreciation on a straight-line basis, even though it uses accelerated depreciation on its tax return. This results in higher tax allowances in the early years of an asset's life (and lower allowances in later years) than would result from using the depreciation actually claimed by the utility on its return, with the difference removed from the utility's rate base by means of a deferred account. *See, e.g., Public Systems v. FERC*, 709 F.2d 73, 75-77 (D.C.Cir. 1983); *Memphis Light, Gas & Water Division v. FERC*, 707 F.2d 565, 567-69 (D.C.Cir. 1983); *Public Systems v. FERC*, 606 F.2d 973, 975-76 (D.C.Cir. 1979).

tax saving. *See* 281 F.2d at 573-74.[8] *See also Cities of Lexington, etc., Ky. v. FPC*, 295 F.2d 109, 111-19 (4th Cir.1961) (following *El Paso* on these issues).

Subsequently to *El Paso*, the Commission determined that because the total depreciable plant of utilities was likely to grow or remain stable in the foreseeable future, meaning that excess depreciation deductions would be continuously available, accelerated depreciation would realistically result in tax *savings* rather than merely deferral, and it changed its policy to require flow-through. That decision was also upheld by the Fifth Circuit, *see Alabama-Tennessee Natural Gas Co. v. FPC*, 359 F.2d 318, 336-39 (5th Cir.), *cert. denied*, 385 U.S. 847, 87 S.Ct. 390, 17 L.Ed.2d 310 (1966), and by this court, *see City of Chicago, Ill. v. FPC*, 385 F.2d 629, 633-34 (D.C. Cir.1967), *cert. denied*, 390 U.S. 945, 88 S.Ct. 1028, 19 L.Ed.2d 1133 (1968). In support of our affirmance we alluded to the "general rule followed by the Commission, and indeed most if not all regulatory commissions, . . . that the 'consumers should be charged for only the actual liability for Federal income taxes.'" 385 F.2d at 633 (quoting *United Fuel Gas Co.*, 12 F.P.C. 251, 265 (1953)).

In a later case, however, we rejected a challenge to the Commission's use of area rates[9] grounded squarely on the "actual taxes paid" principle, because the propriety of

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[8] Of course, even a "tax deferral," *i.e.*, a larger deduction today that is exactly offset by a smaller deduction tomorrow, results in a tax *saving* because of the time value of money.

[9] An area rate "is essentially a rate predicated on a composite rather than an individual cost-of-service. Cost data are gathered from all producers engaged in natural gas production in a given area and weighted average costs plus an appropriate rate of return are used to derive a price for gas produced in that area and sold in interstate commerce." *City of Chicago, Ill. v. FPC*, 458 F.2d 731, 736 (D.C.Cir. 1971), *cert. denied*, 405 U.S. 1074, 92 S.Ct. 1495, 31 L.Ed.2d 808 (1972) (footnote omitted).

area-wide calculation of costs in general was not subject to question, *see Permian Basin Area Rate Cases*, 390 U.S. 747, 88 S.Ct. 1344, 20 L.Ed.2d 312 (1968),.and there was no reason to treat taxes differently from other costs. *See City of Chicago, Ill. v. FPC*, 458 F.2d 731, 754-56 (D.C. Cir.1971), *cert. denied*, 405 U.S. 1074, 92 S.Ct. 1495, 31 L.Ed.2d 808 (1972). We said in *dictum*, however, that "[w]hen a company's rates are set under *individual* cost-of-service . . ., only actual costs—tax and other—can be included." 458 F.2d at 756 (emphasis added).

If taken literally, the *dictum* would have utterly invalidated normalization. Such a conclusion was recognized and rejected by this court in *Memphis Light, Gas & Water Division v. FPC*, 500 F.2d 798 (D.C.Cir.1974). There Texas Gas Transmission Corp. sought and was granted a rate increase based on its change from flow-through to normalization of certain tax deductions. We found "no conflict between the rate increase . . . and the 'actual expenditures theory,'" *id.* at 807, because "while Texas Gas [was] not currently paying taxes at straight-line rates, it [was] *incurring* the liability [then] to pay increased taxes in the future." *Id.* (emphasis added). This was held not to constitute "an increase of rates based on fictitious taxes," *id.*, for if it was, then normalization, the legality of which was well established, "would always violate the actual taxes paid principle." *Id.* n. 61.

This court's next foray into actual taxes paid arose out of the Commission's nationwide rate orders covering gas produced from wells commenced after January 1, 1975, and prescribing new prices for gas produced from wells commenced after January 1, 1973. Consumers challenged the orders, which included tax components calculated on a nationwide rather than individual basis, on the ground that, by failing to require the use of tax returns to demonstrate actual liability, "the Commission has departed from the well-settled principle of regulation that rates provided to cover tax costs must be based on 'actual taxes

paid.'" *American Public Gas Ass'n v. FPC*, 567 F.2d 1016, 1038 (D.C.Cir.1977), *cert. denied*, 435 U.S. 907, 98 S.Ct. 1456, 55 L.Ed.2d 499 (1978). We held this to be a "misunderstanding of the case law dealing with that principle," 567 F.2d at 1038, explaining:

> In rate regulation there is no mystique requiring that expenses be actually "paid." Regulated companies are routinely permitted to set up reserves against the probable expenses of obligations undertaken now yet falling due in the future even when the amount of obligation is subject to revision. . . . [T]here is no historical basis for petitioners' simplistic interpretation of the "actual taxes paid" principle.

Id. On the heels of this case came *Tenneco Oil Co. v. FERC*, 571 F.2d 834 (5th Cir.), *cert dismissed*, 439 U.S. 801, 99 S.Ct. 43, 58 L.Ed.2d 94 (1978), which upheld the nationwide rate orders for gas produced from wells commenced before January 1, 1973, including their use of a nationwide tax allowance. Although finding that "[t]he Commission ha[d] not shown that its income tax component [was] strictly cost-justified," 571 F.2d at 844, the court approved the component as "a reasonable effort to construct a rate element that would confront the reality of the tax laws rather than pretend they do not apply." *Id.* More recently, this court has approved the Commission's decision generally to employ normalization in calculating tax allowances, deferring to its judgment that normalization will not result in tax savings. *See Public Systems v. FERC*, 709 F.2d 73, 81-82 (D.C.Cir.1983).

We conclude from these and from other cases[10] that the imprecision of the "actual taxes paid" formulation is exceeded only by the name of the Holy Roman Empire:

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[10] *See, e.g., FPC v. Memphis Light, Gas & Water Division*, 411 U.S. 458, 93 S.Ct. 1723, 36 L.Ed.2d 426 (1973); *Public Systems v. FERC*, 606 F.2d 973 (D.C.Cir. 1979).

two out of the three words are wrong. Taxes, yes. But not necessarily *actual* taxes, since inexact estimations are often allowed, *e.g.*, a nationwide tax allowance applied to all individual utilities, *see Tenneco Oil*, 571 F.2d at 844. (In point of fact, of course, even the use of *actual* taxes for the test year by which future rates are calculated rarely succeeds in the objective of precisely estimating the actual taxes in the years when the rates are paid.) And not necessarily taxes *paid*, since tax liability incurred by current activities but in fact not paid currently can be charged to present ratepayers, *e.g.*, taxes deferred by reason of accelerated depreciation but passed on to current ratepayers through normalization, *see Public Systems*, 709 F.2d at 81-82. So the principle should be expressed "actual or estimated taxes paid or incurred"—whereupon it ceases to constrain the Commission with regard to taxes any more than the Commission is constrained with regard to its treatment of other expenses. Which is as it should be.

Only one factor makes application of this modest principle to consolidated returns distinctive: The theoretical tax liability for the pipeline's net income may never be reflected on *anyone*'s actual tax bill, since it may be offset by losses of the parent and other affiliates. To take the harshest hypothetical case, if stand-alone is allowed the pipeline ratepayers may be assessed with a tax expense when the consolidated company in fact pays *no* taxes.[11]

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[11] While Charlottesville does not contend that that situation exists here, it does assert that the Columbia pipelines have consistently enjoyed tax allowances in excess of the consolidated tax liability paid by the system. That is questionable since, as the Commission pointed out, Charlottesville's computation contained some obvious errors, such as the failure to account for the fact that the pipelines' tax allowances were "normalized," *see supra* note 7, whereas the consolidated tax bill was not. *See* 23 F.E.R.C. at 61,864, 61,875 n.91; Reply Brief on Remand on Behalf of Columbia Gulf Transmission Company and Columbia Gas Transmission Corporation, Docket Nos. RP75-105 & RP75-106 (Consolidated Taxes) at 4-9 (filed Nov. 18, 1982).

We find that no obstacle to the Commission's action, neither in theory nor in economic reality. It is certainly reasonable to regard as no less real an economic detriment than cash payment of tax assessments, the consumption of otherwise usable tax losses to forestall those assessments. Had the affiliates reporting the losses filed separately, the losses could have been carried forward and used to offset their own income the following fifteen years (or carried back to yield refunds for the previous three); or they could have been used to offset the profits of some other company with which (had the pipeline not been in the consolidated group) the parent would have chosen to affiliate; instead, the parent used them, in place of cash as it were, to eliminate tax liability. Economic detriment to the parent is undeniable, even if, since the losses fully "pay" the tax, the tax bill is zero. One might properly say that the consumption of allowable tax losses cannot accurately be considered a "tax expense" since, though it is related to the assessment of tax liabilities, it does not pay an assessed tax, but rather prevents the assessment of one. But that is no more than a definitional quibble; if it is correct, then the Commission should call this allowable expense a "tax-related expense" instead of a "tax expense"—hardly reversible error. The point is that it is an expense of the consolidated company caused by the jurisdictional activities and thus properly assessed against the ratepayers.

We do not assert, of course, that this is the only rational or permissible view of things. In fact, in arguing that the pipelines' tax expense cannot exceed the consolidated tax liability Charlottesville does no more than place the Commission's own now-disavowed child on its doorstep. That is the principle the Commission explicitly recited in its 1963 *Cities Service* decision, imposing a "flow-through" rather than a "stand-alone" methodology. "[T]he amount of the consolidated tax payment," it said, "is the only real cost which was incurred

by Gas Company in conjunction with the other Cities Services affiliates"; and the purpose of tax allowances is "not to insure that other components of a complex corporate system are enabled to 'cash-in' on their tax losses." *Cities Services Gas Co.*, 30 F.P.C. 158, 162 (1963). In upholding the Commission's action, the Supreme Court appeared to adopt this argument as not permitting but requiring flow-through, *see FPC v. United Gas Pipe Line Co.*, 386 U.S. 237, 243-44, 87 S.Ct. 1003, 1007, 18 L.Ed.2d 18 (1967); *id.* at 254, 87 S.Ct. at 1012 (Harlan, J., dissenting), but as the Fifth Circuit explicitly said in *Tenneco*, *see* 571 F.2d at 843, and as we plainly implied in *Charlottesville I*, *see* 661 F.2d at 952, those expressions were *dicta*.

It can be argued that the parent's consumption of tax loss allowances is *not necessarily* an economic detriment, since those allowances might have been valueless in any event. The Internal Revenue Code's carry-back provisions generally extend only three years, *see* 26 U.S.C. § 172(b)(1)(A), and the carry-forward provisions fifteen years, *see* § 172(b)(1)(B), so that if the system were deprived of the pipelines' income as a current set-off, it could accumulate masses of "excess" tax losses that would prove useless because unmatched by other income within the permissible periods. Such speculation, however, involves a number of imponderables. For example, if confronted with the prospect of such "excess" losses the system could choose to capitalize rather than expense certain exploration deductions, which would have the effect of stretching out the tax benefits, making it more likely that the deductions could be used in future years. Or, if "excess" losses were unavoidable and stand-alone treatment of the pipeline was not permissible, the parent might (and rationally would) choose to remove the pipelines from the consolidated group, replacing them with other enterprises that would permit the shareholders (rather than ratepayers) to benefit from the set-off. In an era when enterprises are frequently the objects of acquisi-

tion or merger because of their temporary tax-loss benefits, such a prospect is far from fanciful. This speculation whether consumption of the tax losses represents a real economic detriment is reminiscent of the dispute, in the context of normalization, over whether the taxes deferred by reason of accelerated depreciation will in fact *ever* be paid, or will as a practical matter be postponed forever. *See supra* pages 1213-1214. Just as the courts have left that call to the Commission, permitting it to conclude either way—first allowing normalization and later disallowing it because of indefinite postponement of tax liability, *compare El Paso*, 281 F.2d at 573-74, *with Alabama-Tennessee*, 359 F.2d at 336-39, and *City of Chicago*, 385 F.2d at 633-34—so also we think this matter is one for the Commission's judgment.

In sum, we are persuaded that the Commission's stand-alone approach is reasonable enough to survive our highly deferential review, *see Permian Basin Area Rate Cases*, 390 U.S. at 791, and reaffirm the holding of *Charlottesville I*, 661 F.2d at 949-50, that it is lawful.

IV

It remains to be considered whether the Commission's methodology for allocating tax deductions for stand-alone purposes is reasonable, and whether it has been applied correctly to the facts of this case. The methodology in question is the so-called benefits/burdens test, which the Commission urged as an alternative ground for sustaining its action in *Charlottesville I*, but which we did not reach. That test, first set forth in substance in *Florida Gas*, 47 F.P.C. at 360-63, *see also Southern California Edison*, 59 F.P.C. at 2172-74, assigns to the pipelines those tax benefits (deductions) attributable to expenses whose burden was borne by the pipelines' ratepayers.[12]

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[12] This allocation does not necessarily conform to the IRS's, *i.e.*, it does not hinge upon which firm's tax return would show the de-

The object of inquiry is whether "the customers of a regulated entity contributed to the expenses which created the loss deductions of the affiliate in the consolidated tax group." 9 F.E.R.C. at 61,746. This is on its face eminently reasonable, and we have no difficulty sustaining it in principle.

Despite Opinion No. 173's frequent references to the benefits/burden test, *see e.g.*, 23 F.E.R.C. at 61,851, 61-861-62, Charlottesville asserts that the Commission was in fact not using it, but was inexplicably and without warning departing from its prior precedent to apply a "cost of service" test. This, according to Charlottesville, is "substantively different" and more stringent towards the ratepayers, Reply Brief for Petitioner at 28, since "it is no longer enough that 'the expenses which created the deductions used to achieve the tax savings were paid by the jurisdictional customers'; the expenses must now be paid by the jurisdictional customers in the *pipeline's cost of service.*" Request of the City of Charlottesville, Virginia, for Rehearing of Opinion No. 173, Docket Nos. RP75-105 & RP75-106 (Consolidated Taxes) at 25 (filed July 22, 1983) (quoting *Louisiana Power & Light Co.*, 14 F.E.R.C. (CCH) ¶ 61,075, at 61,124 (Jan. 28, 1981)). We find this argument not merely unpersuasive but totally incomprehensible. Opinion No. 173 does, to be sure, expressly say that "the test is whether the expenses are included in the relevant cost of service," 23 F.E.R.C. at 61,853; but that is plainly an iteration rather than an alteration of the benefits/burdens test. A "cost of service" is a document filed by a rate-regulated utility showing *all* of the items requiring reimbursement from

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ductions if each company in the group filed separately. For example, some of the deductions shown on the pipeline's hypothetical separate return might be attributable to expenses borne by shareholders rather than ratepayers. That is why the Commission distinguishes its stand-alone policy from a "separate return" policy. *See* 23 F.E.R.C. at 61,852-53.

the ratepayers—its bottom line, in other words, is the "R" or "revenue requirement" element of the classic rate-making formula R (revenue requirement) = C (operating costs) + Ir (invested capital or rate base times rate of return on capital). *See* T. MORGAN, ECONOMIC REGULATION OF BUSINESS 219 (1976). *See also* E. GELLHORN & R. PIERCE, JR. REGULATED INDUSTRIES IN A NUTSHELL 97 n. 1 (1982) (citing substantively identical formulae). That being so, it is beyond imagination how the ratepayers could possibly pay an expense without doing so "in the *pipeline's cost of service.*" Charlottesville's argument to the contrary seems to rest upon the astonishing misconception that the phrase "cost of service" refers to "operating costs," *i.e.*, the "C" rather than the "R" in the rate-making formula. Thus, Charlottesville's brief says that "[t]he Commission fulfills [its duty to ensure 'just and reasonable' rates] in part by examining a pipeline's 'cost of service,' *i.e.*, the various operating expenses it incurs in providing service to its customers. . . ." Brief for Petitioner at 14. It suffices to say that this is appallingly wrong. We think it plain, in short, that the cost-of-service test and the benefits/burdens test are one and the same.

We turn, then, to the application of the benefits/burdens test in the present case. When the Commission specifically considered the burdens that Charlottesville maintained justified a sharing of consolidated tax savings, it concluded that "the burdens Charlottesville . . . point[s] to (to the extent they are burdens at all) are simply too far removed from the tax benefits to justify allocating the benefits to the ratepayers." 23 F.E.R.C. at 61,861. This conclusion survives review, though as to some of the items on technical grounds.

Charlottesville suggested first that use of the pipelines' internally generated funds to finance the activities of the gas supply affiliates entitled the ratepayers to a share of the tax savings resulting from those activities. The

Commission disagreed because use of the funds (consisting of profits, depreciation and deferred taxes) did not in its view burden the rate payers, *i.e.*, did not affect their rates. "[W]hat the pipelines' shareholders do with this cash is largely their own business," the Commission said. "They may reinvest it in the pipelines or they may invest it in other business ventures." *Id.* Assuming that to be true (which petitioner has not contested)[13] the Commission's conclusion represents a reasonable application of the benefits/burdens test.

The Commission made essentially the same response to Charlottesville's contention that the Columbia System's practice of "funnelling" money from the pipelines to the gas supply affiliates burdens the ratepayers. This funnelling results from the procedures the System uses to allocate internally its consolidated tax payments. The parent collects money from its subsidiaries to discharge the System's consolidated tax liability. During the relevant time period, however, rather than collecting a portion based on the ratio of each subsidiary's taxable income to the consolidated tax liability, the System, pursuant to an exemption from S.E.C. Rule 45(b)(6), 17 C.F.R. § 250.45(b)(6) (1980),[14] excluded from the consolidated tax liability the savings (deductions) attributable to the gas supply development activities. The other subsidiaries thus paid to the parent more than was needed

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[13] It is of course unquestionably true as to profits. We have no reason to believe it is not true for funds collected from the ratepayers for depreciation and future taxes, which petitioner's argument treats as indistinguishable from profits.

[14] The procedure used by Columbia is now explicitly authorized by 17 C.F.R. § 250.45(c) (1985), which replaced the prior rule on March 25, 1981. *See* 46 Fed.Reg. 18,532 (1981). We note that the allocation rules prescribed by 26 U.S.C. § 1552, pertain only to determination of earnings and profits for accounting purposes and do not prescribe an amount that the parent must collect from each subsidiary in discharge of the consolidated liability. *See* 23 F.E.R.C. at 61,864.

to discharge the current year's tax liability, and the excess was "funnelled" to the exploration and development companies, allowing them to convert their tax-deferring credits into immediate cash for use in the exploration and development efforts. In future years, when the gas supply subsidiaries finally become profitable, they will be allocated additional portions of the consolidated tax liability to offset this early-period funnelling effect. As far as the pipelines' ratepayers are concerned, however, this "funnelling" is somebody else's business. As the existence of this litigation testifies, what the ratepayers contribute to the consolidated tax liability is determined not by the amount of the parent's allocation, but by the amount that the Commission allows as an operating expense. To the extent that the former exceeds the latter, it comes out of the pockets of the shareholders of the pipelines (*i.e.*, the parent itself). We agree with the Commission that, since the internal allocation in no way affects rates, there is, under the Commission's test, no burden entitling ratepayers to corresponding tax benefits. *See* 23 F.E.R.C. at 61,861-62.

The Commission acknowledged that the remaining assertions of "burden" advanced by Charlottesville had "some merit," *id.* at 61,862. One of these was that Columbia Gas made advance payments to Columbia Gas Development Corp. (and to gas supply companies not affiliated with the Columbia System), pursuant to a Commission program designed to increase gas exploration. *See Accounting and Rate Treatment of Advance Payments to Suppliers for Gas and Amending F.P.C. Form No. 2*, 44 F.P.C. 1142 (1970). The advances were to serve essentially as interest-free loans to the producers. To encourage such payments, the Commission allowed pipelines to include them in their rate base and thus to collect a return on the advanced money from the ratepayers.[15]

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[15] This court gave provisional approval to the program as a "justifiable experiment in the continuing search for solutions to

In the present proceeding, the Commission necessarily agreed that this constituted a burden on the ratepayers, but did not consider the burden sufficiently linked with a corresponding tax benefit. "[The] advance payments," it said, "did not create any tax benefits for either the pipeline or the gas supply company. So there is no relationship between this burden and the tax benefits to be allocated." 23 F.E.R.C. at 61,862. The Commission evidently believes that merely contributing the cost of capital for activities that generate tax-deductible expenses, as opposed to contributing to the expenses themselves, does not establish sufficient connection between the burden and the benefit. It means quite narrowly, in other words, its requirement that ratepayers must pay "the expenses which created the deductions used to achieve the tax savings," *id.* at 61,871 n. 17 (quoting *Louisiana Power & Light Co.*, 14 F.E.R.C. at 61,124). We must decline to review the propriety of this approach, because we conclude that the issue is not properly before us. The Natural Gas Act provides that, on a petition for review, "[n]o objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure

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our nation's critical shortage of natural gas." *Public Service Comm'n of New York v. FPC*, 467 F.2d 361, 371 (D.C.Cir. 1972) (on petition for rehearing). After the Commission extended the program (with minor modifications) through 1975, this court found that it had "failed to engage in 'meaningful review, analysis, and evaluation' of the experience under the advance payments program," *Public Service Comm'n of New York v. FPC*, 511 F.2d 338, 342 (D.C.Cir. 1975) (quoting 467 F.2d at 371), and remanded for further consideration. The Commission then allowed the program to terminate as of December 31, 1975. *See Accounting and Rate Treatment of Advances Included in Account No. 166, Advances for Gas Exploration, Development and Production*, 54 F.P.C. 3046 (1975), *modified*, 55 F.P.C. 80[illegible] (1976). The advances at issue in this case were all properly included in rate base during periods when the program was still in effect.

so to do." 15 U.S.C. § 717r(b). Nothing resembling an objection to the Commission's holding on this point was argued to the Commission. The rehearing petition assigned as error the Commission's "holding that the payment by the Columbia pipelines of advance payments to Columbia Gas Development Corporation did not constitute enough of a burden to the Columbia pipelines' ratepayers to justify the sharing of consolidated tax savings with those ratepayers." Request of the City of Charlottesville, Virginia, for Rehearing of Opinion No. 173 at 5. As we have described, however, FERC did not contest the reality or substantiality of the burden, but rather held that the corresponding benefit was too remotely related. Nor can we find the proper issue fairly raised by the rehearing petition's argument, which simply protested the Commission's alleged substitution of the cost-of-service test for the "contribution to expenses" test of Opinion No. 47-A and the "payment of expenses" test of *Louisiana Power & Light Co.*, 14 F.E.R.C. at 61,124. *See* Request of the City of Charlottesville, Virginia, for Rehearing of Opinion No. 173 at 25, 28.

Charlottesville's other assertion of burden acknowledged by the Commission to have had "some merit" suffers from the same infirmity, as far as this appeal is concerned, of having been rejected by the Commission on a basis that Charlottesville did not contest on rehearing. In calculating the pipelines' rates of return, the Commission, with the agreement of all parties including Charlottesville, had used the capital structure, cost of debt, and cost of equity of the parent, the only company in the system that sells securities to the market. Charlottesville contends that because the gas supply companies increase the parent's cost of debt and equity (financing for exploration and production being more expensive than for other, less risky system activities), the rates of return for the pipelines reflect a "risk premium" attributable to the gas supply companies' activities—and that the ratepayers should share in the tax benefits this burden generates. The

Commission agreed that there was a "risk premium" burden on the ratepayers as to debt costs, though not as to equity costs, *see* 23 F.E.R.C. at 61,863, 61,875 n. 83, and said that "[t]his evidence might justify, on purely equitable grounds, some sharing of the consolidated tax savings if there were no other way to protect the ratepayers from this increased cost of capital," *id.* at 61,863.[16] The Commission contended, however, that a superior way to protect the ratepayers is to adjust the rate of return to take account of these concerns. It catalogued a number of cases in which adjustments to the capital structure and capital costs used in the rate of return calculation were made—or endorsed in principle—in similar situations. *Id.* Hence, "nothing prevented the parties from raising their concerns that the return was too high when that issue was presented to the Commission for decision. But they did not. Instead, they settled." *Id.* (footnote omitted). FERC thus declined to use the tax allowance calculation to correct a rate of return calculation better dealt with directly during the settlement process (or in litigation over the proper rate of return). *Id.* Despite this explicit statement of the Commission's reasons, Charlottesville's assignment of error in its rehearing petition was that:

> The Commission erred in holding that the use of the parent company's cost of raising debt and equity capital and the parent's capital structure (which reflect the increased business risks of the Columbia system's unregulated subsidiaries) in setting the Columbia pipelines' rate of return did not constitute a burden to the ratepayers that would justify the sharing of consolidated tax savings.

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[16] Why "equitable grounds" would have to be invoked, rather than straightforward application of the benefits/burdens test, is not evident. Perhaps the Commission had reference to the same insufficiency of connection between the burden and the benefit that in its view had invalidated the interest-free loans.

Request of the City of Charlottesville, Virginia, for Rehearing of Opinion No. 173 at 6 (footnote omitted). This did not place the Commission's actual reasoning in issue, and hence we must decline the request to review it here. We might add, with regard to both of the last two points, that Charlottesville not only utterly failed to address the Commission's actual holdings in its rehearing petition and argument, but only by the most sympathetic interpretation can be said to have addressed them before us. Particularly in a case as complex, for both the Commission and the courts, as this ratemaking proceeding, our refusal to rescue litigants from the consequences of their confusing imprecision is not only a required course but a fair and efficient one.

Finally, Charlottesville makes a more broad-based attack on the Commission's application of the benefits/burdens methodology. That application represents, Charlottesville maintains, a one-sided view of the tax consolidation process, since it implicitly assumes that the benefits of that process are attributable exclusively to the availability of "excess" deductions—*i.e.*, deductions that would (if separate filing were made) exceed an affiliate's taxable income. Under the Commission's approach, only when a pipeline contributes to production of those deductions is it regarded as contributing to the tax benefits. In fact, however, excess deductions are valueless (or, if there are carry-forward possibilities, of lesser and uncertain value) unless there is past or current taxable income to offset. The tax benefits of consolidation are, in other words, a synergistic product that requires both income *and* deductions. Hence, Charlottesville argues, the Commission should make some allowance to the pipelines' ratepayers for the fact that the steady stream of taxable income they provide to the consolidated group helps give immediate and certain value to the deductions of the loss companies. The argument is simply a rerun, in the context of methodology, of the fundamental objection to stand-alone ex-

pensing that we discussed earlier. No more in this context than there is it a proper basis for overturning the Commission's judgment. The object of the present exercise is not theoretically accurate assignment of causality for the tax advantages of consolidated filing, but estimation of the tax liability attributable to operations of a regulated company that happens to be an affiliate. There are a number of plausible ways to make that estimation —ranging, perhaps, from an approach that would give the utility's ratepayers the benefit of all tax deductions of the consolidated group offset against the utility's income (since the deductions would have been worthless without the income) to an approach that would give ratepayers the benefit of none of them (since the utility would have had no deductions on its own). Within certain rational limits that have clearly not been exceeded here, which approach to choose is more a matter of regulatory policy than of logic. The approach the Commission has chosen, allowing those deductions made possible by charges to the ratepayers, is an entirely reasonable one, beyond our authority to upset. *See FPC v. United Gas Pipe Line Co.*, 386 U.S. 237, 246, 87 S.Ct. 1003, 1008, 18 L.Ed.2d 18 (1967); *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 589, 65 S.Ct. 829, 833, 89 L.Ed. 1206 (1945); *Charlottesville I*, 661 F.2d at 952.

V

As noted earlier, the Commission, with the agreement of all parties, uses the capital structure and capital costs of the parent, Columbia Gas System, Inc., to determine the pipelines' rates of return. Since the parent has more debt in its capital structure than the pipelines, and pays outside creditors of the system a marginally higher interest rate than it charges its affiliates, the effect of this treatment is to increase the pipelines' debt costs,[17] which

[17] As will be discussed shortly, this increase does not necessarily produce a net increase in the allowed rate of return, since it is

are charged to the ratepayers in the cost of service. The Commission agrees with Charlottesville that since the the ratepayers bore the "burden" of those higher costs, they should enjoy the tax "benefits" attributable to them. The difference between the parties is that the Commission contends, and Charlottesville denies, that the stand-alone method in fact achieves this result.

At first blush, the Commission would seem to be correct, since, when calculating stand-alone tax allowances, the Commission permits interest-expense deductions based, like the rates, upon the *parent*'s interest costs and not upon the lower costs of the pipelines. Charlottesville points out, however, that this is required ratemaking procedure *even when no consolidated tax return is filed*, because it "synchronizes" the interest costs used in calculating the rate of return and tax allowance; and that it alone therefore does not pass through to ratepayers a share of the consolidated tax savings gained by having the parent join in a consolidated return.

But for the fact that we took this argument seriously in *Charlottesville I*, we would be inclined to say that it makes no sense. Consolidated tax savings cannot be passed through unless consolidated tax savings exist, and we are here talking about a situation in which there concededly *are* none—*i.e.*, the portion of the interest expense deduction on the consolidated return allocable to each pipeline's operations, and the interest expense deduction on each pipeline's hypothetical stand-alone return *are precisely the same*. That should be the end of the matter. It is no more rational to require this deduction to be run through the stand-alone return a second time than it would be to accord similar double-counting treatment to salaries, rents, and many other deductions that are reflected on both the consolidated and the stand-alone returns.

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accompanied by a *decrease* in the cost of equity capital, due to the *lesser* proportion of that more costly element in the parent's structure.

Charlottesville's response is, in effect, that the interest expense deduction differs from the other deductions on the stand-alone return in that it does *not* reflect a proper expense of the pipeline, but is improperly allowed to be deducted against taxes only because it was improperly allowed to be charged to ratepayers; and that it would undo this two-wrongs-make-a-right adjustment to refuse to give the pipelines the benefit of the *real* expense reflected on the consolidated return. Charlottesville does not put the point this way, but that is what it comes to. The premise of the argument is that the parent's capital structure and costs, which are attributed to the pipelines for ratemaking purposes, do not accurately reflect the pipelines' cost of capital; and that allowing the parent's interest expense to be deducted on the stand-alone returns does no more than compensate for this inaccuracy. The Commission's response to this was in part as follows: "[I]n this case the parties, including Charlottesville, have agreed to use the parent's capital structure and costs. That agreement is final. So it is too late to complain now that the return is too high." 23 F.E.R.C. at 61,869. As an original matter, that seems to us entirely correct. We do not think an agreement that imputed capital structure and costs are proper can be distorted into an agreement that imputed capital structure and costs, though improper, are compensated for by an improper tax allowance—especially since the tax allowance would only recover a percentage of the interest charges improperly assessed against the ratepayers. We think the terms of our remand in *Charlottesville I*, however, preclude this response. The mandate of that decision was for the Commission to "consider whether the capital distribution tax benefits are in fact passed-through to ratepayers or whether the pass-through is vitiated by rates premised on a rate base [18]

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[18] The term "rate base" was of course inadvertent, and should have been "rate of return." The debt costs we are here discussing would not be reflected in the rate base, or invested capital ("I" in the rate-making formula discussed earlier, *see supra* page 1217),

which is inflated by the parent's cost of capital." 661 F.2d at 952. If this means anything, it is that Charlottesville was entitled to raise, and the Commission required to address, the relationship between the tax allowance and the rate of return. The Commission addressed that point as well:

> [D]espite its statements to the contrary, Charlottesville's position is that using the parent's capital structure and costs has inflated the return. Is this so? Nothing in the record shows that a return based on the pipelines' own capital structure and costs would be lower. But even if there were, we could not conclude that the return is inflated. As we have said previously, where a subsidiary issues no securities to the public, its capital structure and costs should not be used. Those elements have been determined by the parent, not the market. The parent can manipulate those elements for its own advantage. That cannot be permitted.

23 F.E.R.C. at 61,869 (footnotes omitted).

We agree with the Commission on both counts. Nothing in the record establishes that use of the pipelines' own capital structure and costs would have produced a lower rate of return. Charlottesville prepared an exhibit purporting to show that if the pipelines' capital structures and costs [19] were used, the rate would have been 9.06 percent instead of the settlement rate based

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which would remain the same regardless of its division between debt and equity; but rather in the allowable rate of return on that capital ("r" in the formula), which varies according to the mix between debt and equity and according to the interest actually paid on debt.

[19] The exhibit shows the pipelines to be composed of 56.37 percent debt (at 6.40 percent) and 43.63 percent equity (at 12.50 percent).

upon the parent's capital structure and costs,[20] of 9.49 percent. The Commission questioned the usefulness of the exhibit because "the 9.06% rate of return was not based on a test year estimate of interest expense. It was based on amounts recorded on the pipelines' books." *Id.* at 61,876 n. 121. That was clearly a valid criticism. If one takes the test year interest (7.29 percent), rounds it down to the nearest one-tenth of one percent as the parent regularly does for intra-system loans (7.20 percent), and substitutes this figure for the 6.40 percent used in Charlottesville's exhibit, the "actual" rate of return is 9.51 percent, which is *higher* than the settlement rate. It is true, as Charlottesville notes, that the pipelines' lower debt/equity ratio would, all else being equal, reduce their costs of equity (by reducing risk), but the record contains nothing to establish (1) that all else is equal and (2) that the adjustment in the costs of equity would push the "actual" return below the settlement figure of 9.49 percent.

More fundamentally, however, we also agree with the Commission that even if the pipelines' "actual" capital structures and debt costs yielded a lower return, the Commission was under no obligation to use them. The Commission quite reasonably determined that the capital structures and intra-system borrowing costs of wholly owned subsidiaries reflect the convenience of the parent, which may or may not accord with market reality. That being so, the only options are to use the structure and costs of the parent (which are, or at least should be, determined by market reality) or to create hypothetical structures and costs. Thus, if Charlottesville wished to argue that the rates of return calculated using the former were inflated (producing a distortion which the

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[20] As reflected in the settlement rate of return study, the parent was composed of 56.80 percent debt (at 7.29 percent), 4.08 percent preferred stock (at 11.27 percent), and 39.12 percent common stock (at 12.50 percent).

stand-alone tax deduction, even though less than the distortion, was designed to set off), the proper comparison was with rates calculated not on the basis of the pipelines' artificial "actual" structures and costs, but on the basis of hypothetical arrangements reflecting market realities. We find nothing in the record suggesting that the latter would have been lower than the settlement rate of return. Moreover, in light of the Commission's recent rejection of the use of hypothetical capital structures, *see supra* page 1210 note 5, it may be that it is no longer possible to establish a capital-inflated rate of return except by reference to the parent's capital structure—*i.e.*, by showing that the parent's capital costs are excessive or that its debt/equity ratio is too low.

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For the reasons stated, the petition for review must be *Denied.*

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Docket No. RP75-105-002

COLUMBIA GULF TRANSMISSION COMPANY

Docket No. RP75-106-006
(Consolidated Taxes)

COLUMBIA GAS TRANSMISSION CORPORATION

Opinion No. 173; Opinion and Order Establishing Proper Cost of Service Treatment of Tax Liability Arising from the Filing of a Consolidated Tax Return

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(Issued June 22, 1983)

Before Commissioners: C. M. Butler III, Chairman; Georgiana Sheldon and Oliver G. Richard III.

Appearances

John H. Pickering, Timothy N. Black, Andrea Timko Sallet, Richard T. Hiegel, Giles D. H. Snyder, Glen L. Kettering, and *James E. Coleman* for Columbia Gulf Transmission Company and Columbia Gas Transmission Corporation

Edward Berlin and *Andrew D. Weisman* for New England Power Company, Appalachian Power Company, Columbus and Southern Ohio Electric Company, Indiana & Michigan Electric Company, Kentucky Power Company, Kingsport Power Company, Michigan Power Company, Ohio Power Company, and Wheeling Electric Company

Richard Solomon, David D'Alessandro and *David E. Blabey* for the Public Service Commission of the State of New York

William T. Miller for the City of Charlottesville, Virginia

James T. McManus and *Dale A. Wright* for the Interstate Natural Gas Association of America

Hodges B. Childs and *James A. Biddison* for Baltimore Gas & Electric Company

Rose T. Lennon for Washington Gas Light Company

Frederick L. Jaffe, William A. Thielen, and *Demetros G. Pulas* for the Staff of the Federal Energy Regulatory Commission

I.

Columbia Gas Transmission Corporation owns and operates an extensive pipeline system in the Appalachian and Atlantic coast regions. It sells natural gas at wholesale to a number of distribution systems. The company has much of its gas transported to it by Columbia Gulf Transmission Company, which owns and operates a pipeline extending from the Gulf Coast to Appalachia. In May 1975 each pipeline company tendered for filing increased rates.[1] As part of the justification for the increased rates, each pipeline included in its cost of service and [sic] allowance for federal income tax expense. Each pipeline determined its tax allowance as would any other company seeking an increase in rates from this Commission—by applying the applicable statutory tax rate to, essentially, the allowed return on equity.[2]

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[1] The pipelines' proposed rates were accepted for filing and suspended on July 14, 1975, and became effective, subject to refund, on December 15, 1975. The rates remained in effect through November 1976, when they were superseded by the pipelines' proposed rates filed in Docket Nos. RP76-94 and RP76-95.

[2] For a fuller discussion of how the pipelines calculated their tax allowances, see *infra* p. 11.

The City of Charlottesville, Virginia, a customer of Columbia Gas Transmission, contends that, because the pipelines are not like most other rate applicants, this method of determining the tax allowance produces excessive rates. Hence the question before us is whether the method the pipelines have used produces a just and reasonable tax allowance. We hold that it does.

II.

The facts that give rise to the controversy are straightforward. They are as follows: Columbia Gas Transmission and Columbia Gulf Transmission are wholly owned subsidiaries of Columbia Gas System, Inc. Besides owning all the stock and debt securities of the pipelines, the parent owned during the time in question all the stock and debt securities of 14 other companies. Because the parent is the sole owner of each of its subsidiaries, the group has a choice as to how it will report its income to the Internal Revenue Service. The group may have each company file a return for itself and pay a tax on its own taxable income. Alternatively, the group may have the parent file a consolidated return and pay a tax on the group's consolidated taxable income.[3] Since 1947 the Columbia group has elected to have the parent file a consolidated return.

The rules governing the calculation of consolidated taxable income are quite complex and detailed. But the basic conception underlying them is simple. It is that:

> [T]he consolidated group constitutes, in substance, a single taxable enterprise, despite the existence of technically distinct entities; as such, its tax liability ought to be based on its dealings with "outsiders," rather than on intra-group transactions. This "sin-

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[3] Permission to file a consolidated return is granted in Section 1501 of the Internal Revenue Code of 1954, 26 U.S.C. § 1501 (1982) [hereinafter cited as I.R.C.].

> gle taxpayer" concept lies at the heart of the treatment, both past and present, of intercompany transactions which, in general, are eliminated in computing the group's consolidated taxable income. In effect, the results are not unlike the "joint return" treatment of husband and wife.[4]

Once these adjustments are made, each member's various items of income and deductions are combined on the standard corporate income tax return. The taxable income shown there is the consolidated taxable income. The statutory rate is then applied to derive the group's consolidated tax liability.

The principal advantage of filing a consolidated return over filing separate returns occurs when one member of the group has deductions that exceed its income, that is, when it has a tax loss. If separate returns were filed, the deductions would eliminate the company's income, and the company would pay no income tax. But the excess deductions would have no further tax reducing effect for the company or the group in that year. On a consolidated return, however, those excess deductions can be used to reduce the taxable income of other members of the group. Hence in a year when one member of the group has deductions in excess of its income, the tax liability of the group will be less if a consolidated return is filed than if each member filed a separate return. The difference between the tax liability the group reports on the consolidated return and the tax liability the group would have reported had each member filed separately is often called a "tax savings."

During the test year, 1974, six members of the Columbia group had deductions that exceeded their income. So the group realized a tax savings by filing a consolidated tax return. The losses of five of these companies—the

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[4] Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, § 15.23 (3rd ed. 1971).

parent and four companies engaged in developing new gas supplies for the system—are relevant here.[5]

III.

The City of Charlottesville contends that the tax savings created by offsetting the excess deductions of the five companies against the income of the other members of the Columbia group, including the pipelines, must be shared with, or flowed through, to the pipelines' ratepayers. This is so, Charlottesville argues, because the tax allowance for a utility is limited by established regulatory principle to the taxes it actually pays. According to Charlottesville, the pipelines' actual tax responsibility is a *pro rata* share of the consolidated tax liability. Since the consolidated tax liability reflects the tax reducing effects of using the excess deductions of the loss companies to reduce the taxable income of other members of the group, a tax allowance based on a *pro rata* share of the consolidated tax liability flows an equal share of the savings through to the pipelines' ratepayers.[6] Because the pipelines' tax allowances are greater than their *pro rata* share of the consolidated tax liability, Charlottesville argues that the tax allowances are excessive.

The Public Service Commission of the State of New York supports Charlottesville's position.

The pipelines, who are supported by our staff, a group of electric utilities, and the Interstate Natural Gas Association of America, take a different view. The pipelines

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[5] The four gas development companies are: Columbia Gas Development, Columbia Gas Development of Canada, Columbia Coal Gasification, and Columbia LNG.

The sixth loss company was Columbia Gas of West Virginia, which distributes gas at retail. No issue concerning this company is now before us. For an explanation, see *infra* notes 8 and 26.

[6] We will explain how Charlottesville proposes to implement its recommendation below. *See infra* p. 15.

concede that their tax allowances do not reflect any of the tax savings produced by the excess deductions of the four gas development companies. But they argue that, as a matter of proper ratemaking policy, those tax savings should not be reflected in the tax allowances. The pipelines contend that this is the correct policy because the ratepayers have not been charged with the responsibility of paying the expenses that gave rise to the excess deductions.

With respect to the parent, the pipelines and their supporters agree with Charlottesville that the savings produced by this company's excess deductions should be flowed through to the pipelines' ratepayers. This is so because the ratepayers have been charged with the responsibility of paying the expenses that gave rise to the parent's excess deductions. But it is the position of these parties that the method the pipelines used to calculate their tax allowances already reflects those savings. Hence, it is argued, no reduction in the tax allowances is justified.

IV.

There are thus two issues before us. One concerns the parent's loss. It is very technical—indeed, it is arithmetical. Does the pipelines' method of calculating their tax allowances flow the tax savings created by the parent's loss through to ratepayers?

The other issue concerns our policy towards utilities that join in filing a consolidated tax return. The precise question before us, though, is not so easily stated. The issue has had a long history at this Commission and at others. The terms of the debate—"actual taxes paid," "phantom taxes," "stand alone," "separate entity"—have acquired many meanings. Their use here suggests the division between the parties is stark and the question before us simple. Are the tax savings to be shared or are they not? Should the tax allowance be based on the consolidated return or should the filing of that return be

ignored and the pipelines treated as though they filed separate returns?

These, however, are not the questions before us. The pipelines join in filing a consolidated tax return. And the Columbia group realizes a tax savings by filing such a return. There is no justification for ignoring that reality. And no one contends that we should.

But saying that resolves nothing. It only creates the problem that must be resolved here. The consolidated tax liability is the liability of a single entity. No amount can be specifically identified as the liability of one member of the group.[7] The same is true of the tax savings. So we must allocate some portion of the liability or of the tax savings to the members of the group. The question we have before us, then, is really the very pragmatic one of how we should do that. Should we, as Charlottesville urges, adopt a method that automatically shares a portion of all the tax savings with the ratepayers? Or should we, as the pipelines urge, adopt a method that shares the tax savings with the ratepayers only when there has been a commensurate sharing of the burdens? Which of these methods is just and reasonable? [8]

We consider the policy issue first.

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[7] Indeed, each member is severally liable for the consolidated tax liability of the entire group. 26 C.F.R. § 1.1502-6(a) (1982).

[8] This is not the first time these issues have been before the Commission. In Opinion No. 47, 8 FERC ¶ 61,002 (1979), and Opinion No. 47-A, 9 FERC ¶ 61,355 (1979), the Commission held that as a matter of policy the tax losses of the gas supply companies should not be used to reduce the pipelines' tax allowances. Among the reasons the Commission gave for this policy was that it was needed to encourage gas exploration and development. The Commission also held that the pipelines' tax allowances already reflected the tax savings produced by the parent's tax loss. Finally, the Commission held that the tax savings produced by the tax loss of the retail distribution subsidiary should not be used to reduce the pipe-

V.

For us, a rate for a gas pipeline or an electric utility is "just and reasonable" when it is cost-justified. That is, the rate should be set so as to allow the company the opportunity to recover the expenses it incurs in providing service and earn, after paying taxes, the allowed rate of return.

That is easy enough to say. But the cost-based standard is difficult to apply. Among the problems is simply the determination of the costs incurred in providing service.

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lines' tax allowances because of the particular circumstances of that company.

The City of Charlottesville then sought review of Opinion No. 47 and Opinion No. 47-A in the Court of Appeals for the District of Columbia Circuit. The Court affirmed the Commission's decision with respect to the tax loss of the retail distribution subsidiary. *City of Charlottesville v. F.E.R.C.*, 661 F.2d 945, 952 (1981). But the Court held that there was insufficient evidence to support the Commission's incentive rationale. 661 F.2d at 954. The Court also found the record incomplete on the treatment of the parent's tax loss. 661 F.2d at 952. Accordingly, the Court returned the case to us.

We then directed that a hearing be held on the issues the Court remanded to us and that the record be certified to us for decision. 20 FERC ¶ 61,036 (1982). That hearing has held, and a voluminous record has been made.

In reviewing this record we have reconsidered the policy question from the ground up. Though we reach the same result on that question as did the Commission in Opinion No. 47 and Opinion No. 47-A, we do so for considerably different reasons. Specifically, we place no reliance on what has come to be called the "incentive rationale" that the Commission relied on in those Opinions. We do so because the policy the Commission applied is broader and more fundamental than one needed to encourage gas supplies. The policy involves a basic decision about the proper way to set cost-based rates. As such, the policy applies not only when a pipeline joins with an exploration affiliate in filing a consolidated return but also when any jurisdictional company, be it a pipeline or an electric utility, joins with other businesses in filing a consolidated return.

The amounts the company records in its books for the year are the starting point. But they are a starting point only. These amounts often do not reflect the costs incurred in providing service during the test year. The amounts may reflect payments for services that were performed earlier or that will be performed later or that benefit other services separately regulated by us, by other regulatory commissions, or that are not regulated at all. And where the company is part of an affiliated group, the amounts recorded on the company's books may reflect payment for services performed for its siblings. Or the company's books may not reflect the expenses its siblings have incurred for the benefit of the ratepayers.

In all these cases the "problem is to allocate to each class of the business [and to each time period and each company] its fair share of the costs." [9] We have developed a number of methods for doing that. These methods vary with the expense at issue and the problem presented. Some are simple and straight-forward. Others are complex and subtle.

Despite the profusion of allocation methods we employ, there is a common thread that ties them together. That thread is the concept of cost responsibility or cost incurrence.[10] Each of the methods attempts to allocate costs to the group of ratepayers in question on the basis of a causal link between the service the company provides them and the expenses the company reports. That this is a fair method of allocation is self-evident. And it limits the allowance for expenses to the costs associated with the goods and services provided in the period.

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[9] *Colorado Interstate Gas Co. v. F.P.C.*, 324 U.S. 581, 591 (1945).

[10] *See e.g., Utah Power & Light Company*, Opinion No. 113, 14 FERC ¶ 61,162, at p. 61,298 (1981), where the Commission said that it "must allocate costs in a manner which reflects cost incurrence."

Taxes are no different from other expenses included in the cost of service. So there should be no difference between the principles used to determine the tax allowance and the allowances for other expenses. And we make no distinction. In both cases we limit the allowance charged to ratepayers to an amount equal to the costs the company incurs in serving them. But the application of these principles is a little different in the case of taxes.

The need for a different application of the principles stems from the fact that the income tax is not simply a tax on income. It is a tax on profits, which is gross income less the expenses incurred in producing income. So the tax allowance should be equal to the tax on the profit the ratepayers will contribute to the company. In short, the tax allowance should be equal to the tax on the company's allowed return on equity.[11] This is so because the allowed return on equity is the amount of profit the company should receive for providing service to the ratepayers.

There are, however, vast differences between our assessment of the profit the company is due and the calculation of the amount by which the company is considered to have been enriched by the Internal Revenue Service. Some of these differences stem from the differences in the revenue that is used in calculating the company's profit. The most obvious difference is that we base our determination of the company's profit on projections of revenue. The Internal Revenue Service uses, of course, the revenues the company either actually receives or accrues the right to receive during the tax year. There are even greater differences in the expenses that are recognized.

Because these differences are so vast, the Commission has found that the taxes the company pays to the Internal

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[11] This is somewhat of an oversimplication. The calculation is slightly more complicated. *See infra* p. 11. But we need not address these refinements here.

Revenue Service are not a reliable guide, even as a starting point, for determining a company's tax allowance. Instead, the Commission has always made its own assessment of the tax cost the company incurs in providing service.

We make that independent assessment by considering the two elements that go into the calculation of taxes—income and expenses—separately. We start by determining the income we expect the company to receive from the particular service in question. There is usually no problem with this. We then consider the deductions from income. This requires an allocation, for just as the expenses recorded in the company's books may be for services performed for different periods or different classes, so also with the deductions reported on the tax return. Here again we allocate on the basis of the customers' responsibility for the deductions.

Because deductions are given for expenses incurred in producing income, the necessary causal link between the ratepayers and the deductions is the expenses the company incurs in providing service. Accordingly, the proper way to allocate deductions is to match the deductions with the expenses included in the cost of service. Thus, when an expense is included in the cost of service, the corresponding tax deduction is also allocated to the ratepayers. In this way any tax reducing benefits, or savings, the company realizes in providing the service are recognized in calculating the tax allowance for the benefit of the ratepayers.

The corollary to this is that when an expense is not included in the cost of service (because the company did not incur that expense in providing service), the deduction created by that expense is not allocated to the ratepayers. To do otherwise would result in the tax savings the company realizes from expenses incurred in providing services to other groups and periods or for its own benefit being used to reduce rates for a particular group of rate-

payers. The tax allowance would then be lower or higher than is warranted by the profit each group provides the company. Since the amount of profit to be provided is the measure of the tax cost the company will incur in providing service, none of the rates for the groups would be cost-justified. Subsidization would inevitably result. One group would bear the burden, but another group would gain the benefit.

VI.

So much for theory. What of its application to the case? How does the method the pipelines have used stack up against this standard?

The short answer to these questions is that the method the pipelines have used stacks up very well. It produces an allocation of the consolidated tax liability that is cost-justified and just and reasonable.

The method the pipelines have used, and the method the Commission has followed since 1972, is one in which "a utility [is] considered as nearly as possible on its own merits and not on those of its affiliates." [12] This method is called the stand-alone method, for "a stand-alone income tax allowance is one that takes into account the revenues and costs entering into the regulated cost of service without increase or decrease for tax gains or losses related to other activities . . ." [13] The stand-alone method results in the tax allowance being equal to the tax the utility would pay on the basis of its projected revenues less deductions for all operating, maintenance, and interest expenses included in the cost of service. In short, it results in a tax allowance equal to the tax on the allowed return on equity.

The mechanics of calculating a stand-alone tax allowance are as follows: From the total return allowed on

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[12] *Florida Gas Transmission Company*. Opinion No. 611, 47 FPC 341, 363 (1972).

[13] Exh. 11 at 4.

rate base are deducted interest expenses (computed by multiplying the rate base by the weighed cost of long-term debt used in determining the rate of return), permanent tax differences, and the effect of the surtax exemption to arrive at the tax base. The tax base is then multiplied by the factor of 48% over 52% (now 46% over 54%) to produce the tax allowance, which includes recognition of the fact that the tax allowance itself is subject to tax when received by the utility and is not deductible. The amount so calculated is the tax allowance.

That the mechanics of calculating a stand-alone tax allowance do not take into account the revenue received and deductions for operating and maintenance expenses is not important. In calculating the tax allowance our policy is that a legitimate expense for cost of service purposes is to be considered to be a legitimate deductible expense in calculating a company's cost of service tax allowance.[14] Accordingly, we can safely ignore the utility's operating and maintenance expenses and the revenues needed to recover those expenses. The only area for concern is the return on rate base.

This may not look like an allocation of the consolidated tax liability. Indeed, it looks like a policy that willfully ignores the consolidated tax liability. At least, this is the way Charlottesville views our stand-alone policy. It says that our stand-alone policy is nothing but a policy that calculates the tax allowance on the false assumption that the pipelines file separate returns and thus ignores the

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[14] This policy is most familiar from our rulemaking on tax normalization. *Tax Normalization for Certain Items Reflecting Timing Differences in the Recognition of Expenses or Revenues for Ratemaking and Income Tax Purposes*, Order No. 144, *FERC Statutes and Regulations* ¶ 30,254 (1981), *reh. denied*, Order No. 144-A, *FERC Statutes and Regulations* ¶ 30,340 (1982), *aff'd sub nom., Public Systems v. F.E.R.C.*, Nos. 82-1183 *et al.* (D.C. Cir. May 31, 1983).

tax savings the group realizes by filing a consolidated return.[15] This is incorrect.

A separate return policy assumes that the tax allowance should be equal to the tax the jurisdictional service would pay if it filed a separate return. Under a separate return policy the tax allowance would equal the tax the jurisdictional service would pay on its projected revenues less the deductions that would be shown on its return. A separate return policy thus ignores the consolidated tax return and reflects in the tax allowance none of the tax reducing benefits the group realizes from filing a consolidated return.[16]

Our stand-alone method is different. It does not ignore the consolidated return or the tax reducing benefits the group realizes by filing such a return. Unlike a separate return policy, our stand-alone policy in effect looks beneath the single consolidated tax liability and analyzes

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[15] Brief for Charlottesville at 12; Exh. 13 at 11.

[16] It is doubtful whether a separate return policy could ever be put into operation. The problem is, of course, that the company does not file a separate return. So we would have no way of really knowing what its taxable income would be if it filed such a return. To be sure, appended to the consolidated return is a calculation of each member's "separate taxable income." But the separate taxable income used in preparing the consolidated return "differs sharply from the separate taxable income of the members that would be reported on separate returns." Peel, *A Treatise on the Law of Consolidated Federal Income Tax Returns* § 5.03 (2d ed. 1973). *See also supra* p. 2. Even if these differences were ignored, there would be other problems. Many deductions permitted by the Code are elective. For example, certain interest during construction and intangible drilling costs may be deducted when incurred or capitalized and depreciated later. Hence a separate return policy requires an assumption about the deductions the jurisdictional service would report if it filed a separate return. Presumably, the assumption would be that the jurisdictional service would report deductions in exactly the same manner as the group does on the consolidated return. Whether the service would do so if it in fact filed a separate return is open to question. *See* Exh. 5 at 12; Tr. 247, 425.

each of the deductions used to reduce the group's tax liability to determine the deductions for which each service is responsible. It then allocates to the jurisdictional service those deductions which were generated by expenses incurred in providing that service. In making this allocation it is irrelevant on which member's return the deductions would be reported if the group filed separate returns. Instead, the test is whether the expenses that generate the deduction are used to determine the jurisdictional service's rates.[17] Put more simply, the test is whether the expenses are included in the relevant cost of service. If they are, the associated deductions and their tax reducing benefits will be taken into account in calculating the tax allowance for that cost of service. If the expenses are not, the deductions will not be taken into account. In this way the tax allowance will reflect the profit the ratepayers contribute to the group's consolidated taxable income.

Application of our stand-alone policy to the facts of this case results in some of the tax reducing benefits the Columbia group realizes from filing a consolidated return being used to reduce the pipelines' tax allowances. Specifically, the benefits the group realizes from including the parent are used to reduce the pipelines' tax allowance; the tax benefits realized by including the four supply companies are not.

The parent reports a tax loss because its deduction for the interest expense it incurs in servicing its debt exceeds

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[17] *Louisiana Power & Light Company*, Opinion No. 110, 14 FERC ¶ 61,075, at p. 61,124 (1981) ("The test [for determining when the consolidated tax savings should be flowed through to the jurisdictional customers] is whether the expenses which created the deductions used to achieve the tax savings were paid by the jurisdictional customers."); *Southern California Edison Company*, Opinion No. 821, 59 FPC 2167, 2174 (1977).

its income.[18] By filing a consolidated return this loss is used to reduce the taxable incomes of the pipelines and other members of the group. Hence the parent's interest expense creates a consolidated tax savings.

In setting the return for the pipelines we used the parent's interest expense as the pipelines' cost of debt. Thus, the ratepayers bear the burden of paying the parent's interest expense. That being so, an equal portion of the parent's interest expense deduction must be allocated to the pipelines' ratepayers. Our stand-alone policy does just this.[19] In this way it reflects in the tax allowances a portion of the consolidated tax savings created by the parent's loss.[20]

In 1974 the four supply companies were in various stages of starting their operations. So they had little or no revenue.[21] But because of certain provisions of the

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[18] The parent also incurs some expenses in serving stockholder accounts and paying its directors. These expenses are deductible. But there is no issue here that these deductions should be used to reduce the pipelines' tax allowances.

[19] We will explain in more detail how this is done. *See infra* pp. 50-57.

[20] Under a separate return policy the result would be different. The tax allowance for the pipelines would be calculated by using the pipelines' lower interest expense deductions because those are the deductions the pipelines would report if they filed separate returns. Under a separate return policy none of the tax reducing benefits the Columbia group realizes by offsetting the parent's loss against the income of the group would be reflected in the pipelines' rates.

[21] Columbia LNG began operating a plant for the manufacture of synthetic gas in 1974. The company was also constructing a plant to store and regasify imported liquefied natural gas. Columbia Coal was engaged in the development of methods of converting coal to gas. But it did not produce any gas. Nor did it produce any revenue. Columbia Gas Development of Canada was exploring for gas in Canada and the Arctic. Like Columbia Coal, this company produced neither gas nor revenue. Columbia Gas Development was exploring for gas in the Southwest. This company also produced

Internal Revenue Code they had large tax deductions. Hence each company contributed more deductions than income to the group's consolidated taxable income.

These companies have undertaken their projects to provide additional gas supplies for the system, including the pipelines. But the expenses these companies have incurred were not incurred in providing transmission service. So the requisite causal link between the pipelines' ratepayers and the expenses incurred is missing. The ratepayers were therefore not responsible for these expenses. Accordingly, none of the expenses of the gas development companies were included in the pipelines' cost of services. Because this is so, none of the deductions of the gas development companies should be allocated to the pipelines' ratepayers. And they are not under our stand-alone policy. To hold otherwise would result in tax allowances for the pipelines lower than are called for by the amount of profit the pipelines' ratepayers will contribute. The rates would then not be cost-justified or just and reasonable.

VII.

The method for determining the tax allowance Charlottesville advocates is considerably different. Charlottesville starts with each pipeline's *pro rata* share of the consolidated tax liability. Charlottesville calculates that amount by multiplying the consolidated tax liability by the ratio the pipeline's taxable income bears to the total taxable income of all members of the group having taxable income. Charlottesville then derives an effective tax rate by dividing the pipeline's taxable income into the pipeline's share of the consolidated tax liability. Charlottesville uses the effective tax rate instead of the statutory rate in calculating the pipelines' tax allowances.[22]

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some gas. So this company produced some revenue, but not enough to offset its deductions.

[22] See Exh. 22B for the calculations.

Charlottesville suggested an alternative method that reaches the same result. Under this method the total losses of the group are

We do not find this to be a reasonable method for determining the pipelines' tax allowances. The method focuses solely on the total tax liability and the aggregate reduction. It is oblivious to how that liability and reduction came about. It ignores each member's income and deductions that were combined to produce that liability. But consideration of what each member has contributed is essential. Without knowing that we cannot properly assess each member's and the ratepayers' responsibility for the single tax liability. So the method need not produce—and in this case does not produce—tax allowances that reflect the tax costs the pipelines incur in providing jurisdictional service.

If this were the first case in which this method had been presented to us, this might be a sufficient response. But this is not the first case. Indeed, in a number of cases in the 1940's and 1950's the Federal Power Commission's method for calculating the tax allowance when the regulated entity joined in filing a consolidated return was identical in all essential respects to the method Charlottesville advocates.[23] Hence we need to explain why we no longer follow this method.

We have no quarrel with the results of those cases or the method used to calculate the tax allowances. For the

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multiplied by each pipeline's allocation ratio. The pipeline's share of the losses are then taken as an additional deduction in calculating the pipeline's tax base for the cost of service. The statutory rate is applied to the tax base so calculated. *See* Exh. 23B.

[23] *Michigan-Wisconsin Pipeline Company*, Opinion No. 275, 13 FPC 326, 373 (1954); *Ohio Fuel Gas Company*, 13 FPC 281, 286 (1954); *Home Gas Company*, Opinion No. 272, 13 FPC 241, 246 (1954); *Hope Natural Gas Company*, Opinion No. 262, 12 FPC 342, 347 (1953); *United Fuel Gas Company*, Opinion No. 258, 12 FPC 251, 264-65 (1953); *Atlantic Seaboard Corporation*, Initial Decision, 11 FPC 486, 515, *aff'd*, Opinion No. 225, 11 FPC 43 (1952); *Hope Natural Gas Company*, Initial Decision, 10 FPC 583, 612 (1950), *aff'd*, 10 FPC 625 (1951); *Penn-York Natural Gas Corporation*, 5 FPC 33, 38-39 (1946).

most part the only loss company was the parent.[24] These companies reported a tax loss because they were capitalized like Columbia, and hence, also like Columbia, had interest expense deductions in excess of their income. The Commission held that the tax savings produced by these losses should be shared with the pipelines' ratepayers. We think that is correct. We reach the same result here. And the use of the method Charlottesville advocates here was, given the way rates were determined in those cases, perfectly sensible.[25]

The reason we can no longer follow this method is that the facts we now have to deal with, not only in this case but also in others, are no longer so simple. There are now many other loss companies besides the parent. In most cases there is no justification for reducing a pipeline's tax allowance because of these losses. Hence to continue to use the method the Commission used in the past, we would have to make exceptions for these losses. But the exceptions that would have to be made are so numerous that this would be an enormously complicated and ad-

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[24] This fact does not appear in the Opinions. But the records establish that in all but one instance the parent was the primary, if not only, reason the group realized a tax savings by filing a consolidated tax savings. The one exception was the first consolidated tax case, *Penn-York Natural Gas*. The record in that case does not reveal the source of the tax savings.

In three cases, *United Fuel Gas*, *Ohio Fuel Gas*, and *Home Gas*, which all involved the Columbia group for the same time period, some of the tax savings were created by losses incurred by the pipelines' retail distribution affiliates. The Commission flowed those savings through to ratepayers. Since the amounts at issue were very small, we can appreciate why the Commission made no distinction between these tax savings and the much larger tax savings created by the parent's loss. Nevertheless, we have our doubts about this aspect of the Commission's decisions. *See infra* p. 26.

[25] Rates are now determined somewhat differently. Hence a different method must be used to reach the same result. *See infra* p. 57 and note 115.

ministratively impractical way to proceed. Moreover, the method would be so riddled with exceptions that there would not be much of a method left.

That exceptions have to be made to the Commission's prior method to reflect the particular circumstances of a loss company has long been recognized. In the cases where Charlottesville's method was used, the Commission nevertheless excluded tax savings resulting from a non-recurring or atypical loss.[26]

But instances of such losses were rare then. And they are probably rare now. These losses would not by themselves justify a change in method.[27]

What does justify a change are two other factors. One of these is the structure of the industry. Since the 1950's

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[26] *Michigan Wisconsin Pipeline Company*, 13 FPC at 373; *Home Gas Company*, 13 FPC at 246.

This same reasoning was followed by the Commission in Opinion No. 47 with respect to the loss of Columbia's retail distribution subsidiary in West Virginia. That company lost money from 1970 through 1974 because the state public utility commission had imposed a rate moratorium. The moratorium was lifted late in 1974 so the company was expected to have in place rates that would enable it to report taxable income in the future. Because of that, the Commission held that this loss should be ignored in calculating the tax allowances for the pipelines. 8 FERC at p. 61,009. The Court of Appeals affirmed. 661 F.2d at 952.

(We note that this rationale would be equally applicable to the loss of Columbia LNG. Although this company reported a tax loss in 1974, the test year, the company has since reported taxable income in every year but one. *See* Exh. 2, Schedule 3; Exh. 5 at 12-13; Exh. 14, Schedule 16.)

[27] This is, however, an area we would prefer to avoid. Many of the instances where there is an allegedly non-recurring loss have involved and will involve a retail subsidiary that has a tax loss. Since we do not regulate retail subsidiaries, it is very hard for us to form a reliable judgment, absent special circumstances as were present in the case of Columbia's West Virginia retail subsidiary, about when these companies will report taxable income.

pipelines have diversified. They have integrated upstream into production and pipe and compressor manufacturing and downstream into chemicals, fertilizer, and appliances. More importantly, pipelines have moved into other businesses that have nothing to do with the gas business. Pipelines have become involved in such businesses as real estate, financing, packaging, wire manufacturing, textiles, shipbuilding, mining, and even vocational training and employment services.[28]

That diversification causes problems for our regulation is obvious. It may expose the pipeline's ratepayers to a variety of burdens. The diversified activities may incur losses or costs that the company may attempt to pass on to the pipeline's ratepayers. And the riskiness of the activities may impair the company's credit, thereby raising the cost of capital. The universal response of regulators (at least at this Commission) has been to try to isolate the ratepayers from these burdens. The Commission's allocation methods, which are designed to segregate the costs of jurisdictional and nonjurisdictional busi-

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[28] To be sure, pipelines have always been involved in businesses other than pipelining. But what is important here is that since the 1950's it has become increasingly likely that a pipeline has moved into other businesses and that those businesses have little or nothing to do with the gas business. That this is so is obvious. But we need not rely on general knowledge. Statistics tell the story. In 1959 the nine companies that make up Moody's Natural Gas Transmission Index (El Paso Natural Gas Company, Northern Natural Gas Company, Sonat, Inc., Tenneco Inc., Texas Eastern Transmission Corporation, Transco Companies Inc., United Energy Resources, Inc., and Panhandle Eastern Pipe Line Company) derived 81% of their gross revenue from their gas pipeline operations. By 1978 these companies derived only 55% of their gross revenues from their pipelines. In terms of net revenue the decline was even greater, from 78% in 1959 to 37% in 1978. *See Moody's Public Utility Manual, 1960-1979* and *Statistics of Interstate Natural Gas Pipeline Companies, 1960-1978*. (All figures are weighted averages.) For a chart showing the businesses some natural gas pipelines had moved into by 1973, *see* Federal Power Commission, *Natural Gas Survey*, I-3-65 (1975).

nesses, solve many of the problems. But the Commission has gone beyond that to require that the costs of different jurisdictional services, such as gas production, be segregated from the costs of providing transmission service.[29] The Commission has also attempted to limit the capitalization and cost of capital used in setting rates to the capitalization and cost associated with the pipeline business.[30] In short, the response has been to try to regulate the pipeline as an "independent entity" so that it is "considered as nearly as possible on its own merits and not on those of its affiliates." [31]

That too was the Commission's ultimate response to the consolidated tax problem. But that took a while. There were several false starts.[32]

The first consolidated tax case dealing with a diversified company was *Olin Gas Transmission Company* in 1957.[33] Olin explored, produced, and transported gas. The group to which Olin belonged reported a tax loss on the consolidated return because the losses of Olin's parent on its independent gas exploration and development program exceeded the income from Olin and its other subsidiaries.

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[29] *See Pipeline Production Area Rate Proceeding (Phase I)*, 42 FPC 738 (1969), *aff'd sub nom., City of Chicago v. F.P.C.*, 458 F.2d 731 (D.C. Cir. 1971), *cert. denied*, 405 U.S. 1074 (1972).

[30] *See e.g., El Paso Natural Gas Company*, Opinion No. 582, 44 FPC 73, 77, *reh. denied*, 44 FPC 753 (1970), *aff'd* 449 F.2d 1245 (5th Cir. 1971); *Pacific Gas Transmission Company*, Opinion No. 579, 43 FPC 837, 842-43 (1970).

Charlottesville and New York contend that we have not done that here. We disagree. We discuss the question below, pp. 41-45.

[31] *Florida Gas Transmission Company*, 47 FPC at 363.

[32] This is not surprising. The issue is a difficult one. Even a jurist as insightful as Justice Harlan found the issue "elusive." *See F.P.C. v. United Gas Pipeline Co.*, 386 U.S. 237, 248 (1967) (Harlan, J., dissenting).

[33] 17 FPC 695 (1957).

The Commission staff, following the established method, argued that because the group paid no taxes, no tax allowance should be included in Olin's cost of service. The judge and the Commission disagreed and allowed a tax allowance based on the company's return on equity. The Commission did so because the losses arose "from unregulated [*i.e.*, non-jurisdictional] business activities unrelated to Olin's natural gas operation." [34]

The Commission's holding seems sound in theory. As a panel of the Court of Appeals for the District of Columbia Circuit said in a famous *dictum*:

> [W]e are not aware of any principled basis for saying that natural gas consumers should pay less for gas simply because the unlikely hypothesis materializes and, say, Mobil Oil loses money in its Montgomery Ward investment.[35]

But as an administratively practical method, the Commission's holding leaves much to be desired. In many cases it would be easy to tell that the diversified activity is "unrelated" to the pipeline's gas operations.[36] But in other cases the task would not be so easy. The question of what makes an activity related can be answered in many ways. So there would be many questions and many close cases.[37]

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[34] 17 FPC at 703.

[35] *American Public Gas Ass'n v. F.P.C.*, 567 F.2d 1016, 1040 n.33 (D.C. Cir. 1977).

[36] Such activities as financing, real estate, merchandising, wire manufacturing, textiles, and vocational training seem to be so obviously unrelated to the gas business that no discussion would seem to be needed to establish the point.

[37] For example, would gas operations that are downstream from the pipeline, such as retail gas distribution, chemicals, fertilizer, and gas appliance manufacture and distribution, be related? Because these activities are involved in the gas business, they are related in a way. But they provide nothing to the pipeline. So may-

These questions were never answered, however. The diversification movement was just beginning. So cases presenting the question were rare. And in the next case that did present the question the Commission changed policies again.

This occurred in the *Cities Service Gas Company* case.[38] Cities Service Gas Company was a member of a truly diversified company. Besides the gas pipeline company, the parent owned, directly or indirectly, companies that produced oil in the United States, South America, Africa, Canada, the Middle East; that refined oil; that transported oil through a pipeline in the United States and by means of a fleet of tankers; and that owned office buildings. Many of these companies, especially the foreign oil

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be they are not. Gas operations that are upstream from the pipeline, such as exploration and development, seem more clearly related to the pipeline's business. But how is "relatedness" to be determined? Would the production company be related if it intended to produce gas for the pipeline but had not done so at the time the loss was incurred and would not do so at anytime in the foreseeable future? For example, Columbia Coal Gasification's purpose is to produce gas from coal. But this company's activity since its formation has been mainly to buy and sell coal fields and to mine coal for sale. The company has not produced any gas. Nor does it appear that it will anytime soon. *See* Exh. 48 at 1, 7; Exh. 20 at 7.

Columbia Gas Development of Canada had drilled for gas. But it had not found any by the end of 1975. Since then, this subsidiary has found gas in commercial quantities. Exh. 15 at 30. And it wants to sell that gas to Columbia Gas Transmission. But to date the pipeline has not been granted authority to import the gas. Whether it will ever be granted that authority is uncertain. *See* Exh. 48 at 9-10; Exh. 12B at 8; Exh. 20 at 6-7.

Can the activities of these two companies then be described as related to the pipelines' activities?

[38] Opinion No. 396, 30 FPC 158, *reh. denied*, 30 FPC 676 (1963), *rev'd Cities Service Gas Co. v. F.P.C.*, 337 F.2d 97 (10th Cir. 1964). *But see F.P.C. v. United Gas Pipeline Co.*, 386 U.S. at 248, where the Supreme Court rejected the Court of Appeals' reasoning and affirmed the Commission's position in the *Cities Service* case.

production companies, reported losses. On the consolidated return filed by the parent these losses were used to reduce the taxable income produced by the gas pipeline company and others.

The Commission's staff argued that the Commission should adhere to its traditional "actual taxes paid" principle. Following that traditional principle the staff would have allocated the consolidated tax liability the way the Commission had done in the cases from the 1940's and 1950's and as Charlottesville urges here.

The administrative law judge rejected the Staff's argument. He did so because the losses were incurred in activities that were unrelated to the pipeline's business.[39] The Commission also rejected the staff's argument. It found the staff's method artificial and unstable. The Commission did not think the method was satisfactory for ratemaking purposes.[40]

The Commission, however, did not affirm the judge. It developed yet another method. The Commission pointed out that its task was "to determine the proportion of the consolidated tax [liability] which is reasonably attributable to the Gas Company *vis-a-vis* the other Cities Service affiliates." [41] That being so, the Commission said, the principles controlling the allocation of other costs should control the allocation of the consolidated tax liability.[42] In the Commission's view these principles required the "separation between regulated and unregulated costs and revenues." [43]

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[39] 30 FPC at 185.

[40] *Id.* at 162.

[41] *Id.*

[42] *Id.*

[43] *Id.*

Following these principles the Commission developed this method of allocating the consolidated tax liability: (1) separate the companies into regulated (whether by this Commission or some other commission) and unregulated groups; (2) determine the net aggregate taxable income of each group; and (3) allocate the consolidated tax liability between the groups and among the companies of each group on the basis of their respective taxable incomes.[44] The effect of this method was to apply the losses of unregulated companies as an offset first to the taxable income of unregulated companies. If the unregulated group had taxable income after being reduced by unregulated losses, the regulated companies would not share in the tax savings. Only if the unregulated group as a whole incurred a tax loss, would the regulated group share in the consolidated tax savings.

We agree with the Commission's starting point in *Cities Service*. As we have said, the question before us is simply an allocation question. The allocation principles used here should not differ from those used to allocate other costs. We also appreciate what the Commission was trying to accomplish with its distinction between regulated and unregulated companies. Most companies that are unregulated are probably unrelated to the activity of a regulated gas pipeline. So the distinction would exclude most of the losses that should not be used to reduce the tax allowance of the pipeline. And the question of whether the company is regulated or not certainly appears to be more easily answered than the question of whether the company's activities are related or unrelated to the pipeline's business.

But beyond this, we cannot agree with this approach. The distinction between regulated and unregulated and the allocation method the Commission developed to reflect this distinction faces insurmountable problems.

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[44] *Id.* at 164.

Some of these problems are practical. The method is, or at least can be, difficult to apply.[45]

Other problems are more fundamental. One is that the distinction between regulated and unregulated is inconsistent with the principles this Commission uses to allocate costs. Instead, we allocate costs between jurisdictional and non-jurisdictional operations, and, where there are two or more jurisdictional operations, the costs incurred in providing the service whose rates are being determined and costs incurred in providing other services. The simple fact that a company's operations are regulated is quite irrelevant. So the *Cities Service* method does not conform to its own starting point.

Viewing the question more broadly we do not see why the absence of regulation makes a company's loss less

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[45] The practical problems are two-fold. First, it is not at all that clear what makes a company regulated. Is rate regulation required? The Court of Appeals for the Fifth Circuit thought so. *United Gas Pipe Line Co. v. F.P.C.*, 388 F.2d 385, 388, *rev'd on other grounds*, 390 U.S. 71 (1968). But a plausible case can be made that certificate authority or even import authority is sufficient.

The other problem concerns companies that engage in both regulated and unregulated activities. It is clear that the taxable income must be allocated to these activities. *F.P.C. v. United Gas Pipe Line Co.*, 386 U.S. at 247. That task presents many nice questions of fact and methodology. There is no easy way to resolve those questions short of preparing a full cost of service. Where the company is jurisdictional and before us seeking a change in rates that would present no additional burdens. We would have prepared the cost of service anyway. But where the company is either not before us seeking a change in rates or is non-jurisdictional, these questions would significantly add to our burden. For example, to follow the *Cities Service* method in this case would require us to allocate the loss of Columbia LNG to its unregulated synthetic gas operations and its jurisdictional liquefied gas operations. But the company was still building the liquefied gas terminal during the test year of this case. So we had no need to inquire into that company's costs. Yet that is what we would have to do to arrive at the tax allowance for the pipelines. That seems to us to be a little bit wasteful of the Commission's resources.

significant to the task of determining a pipeline's tax costs. Adherence to that view could produce absurd results.[46]

A third problem concerns the loss of a regulated company. Under the *Cities Service* method such a loss is automatically used to reduce the taxable income of regulated companies.[47] Thus, the *Cities Service* method (or, for that matter, the method Charlottesville advocates) permanently assigns the tax savings generated in providing service to one group of ratepayers to an entirely different group of ratepayers, based solely on the fortuity of common ownership. We see no justification for that. If the tax savings are to be shared with any group of ratepayers, they should be shared with the ratepayers of the company that incurred the loss.[48]

Problems like these led the Commission to reassess the whole question and to start afresh in its *Florida Gas* decision.[49] This reassessment rested on two facts. One was that the complicated set of facts presented in the *Cities*

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[46] Hypotheticals are easy enough to think of. For example, in the Columbia system the operations of the parent, Columbia Coal Gasification, the synthetic gas operations of Columbia LNG, and (probably) Columbia Gas Development of Canada are unregulated. Suppose that in the future the unregulated operating subsidiaries made bundles of money and had more than enough taxable income to absorb the parent's loss. Under the *Cities Service* method the tax savings produced by the parent's loss would not be used to reduce the pipelines' tax allowances. But these tax savings should be shared with the pipelines' ratepayers.

[47] In *Cities Service* the regulated company with the loss was a company that transported oil by pipeline. The company was then regulated by the Interstate Commerce Commission.

[48] The point can be put a little more bluntly. The method may look fair to ratepayers of a company with taxable income. But we doubt it looks fair to the ratepayers of the company with a loss.

[49] 47 FPC at 362-63, *supra* p. 10. The Commission noted the problem of using the tax loss of one regulated company to reduce the tax allowance of another regulated company.

Service case was not unique. Instead, as the Commission noted, "there has been an increasing tendency for pipeline affiliates to diversify and to engage in activities completely unrelated to gas pipeline operations or the gas business at all, so that determining a tax allowance for the pipelines' jurisdictional business on the basis of the activities of a far-flung conglomerate bears less and less relationship to the operations in which we are properly interested." [50] The second fact was that with other rate-making questions the Commission had endeavored to isolate the pipeline business from the consequences of that diversification.[51]

In light of these facts the Commission concluded that a pipeline's tax allowance should not be based on the "activities of others in the affiliated group" but instead, like other costs, should be based on the activities of the pipeline itself.[52] Thus, the Commission rejected methods of determining the tax allowance by allocating a pro rata share of the consolidated tax liability and then adjusting that amount by excluding the losses of certain affiliates. In place of these methods the Commission installed the stand-alone method which determines the tax allowance on the basis of the pipeline's own revenue and expenses.[53]

We adhere to that judgment of the Commission. We do so for three reasons. First, the facts the Commission relied on have not changed. Pipelines are still diversified.

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[50] *Id.* at 362.

[51] *Id.* The Commission cited its decision in *El Paso Natural Gas Company*, 44 FPC at 77, *supra* note 30, to exclude the company's investment in its manufacturing affiliate from the pipeline's capitalization.

[52] *Id.* at 363.

[53] In *dicta* the Commission also expressed its view that a change to the stand-alone method was needed to avoid "discouraging" gas exploration. *Id.* at 362. In Opinion No. 47 the Commission applied the stand-alone method in this case largely for this reason.

We, however, do not rely on this rationale. *See supra* note 8.

We have no reason to believe that the diversity in the natural gas industry the Commission observed in 1972 will decrease in any significant way.[54] So the problems diversification poses for our regulation remain.

Second, the stand-alone method is consistent with the principles used to allocate other costs and produces a tax allowance that is rigorously cost based.

Third, though stand-alone is not the only method the Commission could have adopted to resolve the problems posed by diversification and the *Cities Service* method, we think it was the administratively proper one to adopt. The only alternative would have been to return to the method the Commission followed in the 1950's and adjust the results to reflect the facts of diversification by excluding the losses from unrelated and regulated activities as well as non-recurring losses. As we have seen, that can be complicated. And because the exceptions would be numerous, doing so would be time-consuming and administratively burdensome. Like the Commission in 1972, we do not think that burden is warranted. Our conviction on this point is made all the stronger by the other change that has occurred since the 1950's, a change the Commission did not consider in 1972. This change is in the tax laws.

When the Commission articulated the method Charlottesville advocates here, there was little difference between the time expenses were recognized in the cost of service and the time the same expenses were recognized as deductions on the company's tax return. This changed in 1954 with the passage of the Internal Revenue Code of 1954. That Act allowed companies to deduct deprecia-

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[54] The Commission decided *Florida Gas* at the height of the trend towards diversification. In 1972 pipeline operations of the companies in Moody's Natural Gas Transmission Index contributed only 54% of the companies' gross revenues. Since then, pipeline operations have contributed about the same percentage of their companies' gross revenues. *See supra* note 28.

tion, a significant expense, at an accelerated rate. The Commission, however, continued to require that depreciation be included in the cost of service at a straight-line rate.

Thus was born the question of how to treat timing differences in the recognition of expenses for cost of service and income tax purposes. That question is quite simple. The same amount of depreciation expense is recognized in the cost of service and on the company's tax return over the life of the plant. But most of that expense is recognized in the early years on the income tax return while the expense is recognized evenly throughout the life of the plant in the cost of service. The ratemaking question is how to calculate the tax allowance in this situation. Should the tax allowance reflect the recognition of expenses on the tax return, which is called "flow-through"? Or should the tax allowance reflect the recognition of expenses in the cost of service, which is called "normalization"?

The Commission's answer to that question has been to follow a normalization policy. The Commission had done so because a flow-through policy mismatches burdens and benefits. Under flow-through earlier ratepayers receive credit for tax deductions greater than the depreciation expense they pay; later ratepayers receive crdit for tax deductions that are less than the depreciation expenses they pay. Under a normalization policy the tax benefits and expense burdens are matched. This does not mean that tax deductions are being ignored. Quite the contrary. The tax reducing effects of the deductions that are not used to reduce the cost of service in the early years are accumulated in a deferred account, deducted from rate base, and used to reduce the cost of service in the later years.

Once a normalization policy is adopted for dealing with tax and ratemaking timing differences, a policy on con-

solidated taxes that ignores the source of the loss makes no sense.[55] A hypothetical makes this clear.

Assume that H, a holding company owns two subsidiaries: A, a gas pipeline, and B, an electric utility. In 1982 B puts into service a new generating unit. Because that new unit generates not only electricity but also a large amount of accelerated depreciation deductions, B's deductions exceed its income by $100. A, on the other hand, has taxable income of $100. A, B, and H file a consolidated return. The consolidated income is zero, so there is no consolidated tax liability. Because A would have had a $50 tax liability if separate returns had been filed, the filing of a consolidated return produces a tax savings of $50.

In setting rates for B we would, following our normalization policy, calculate B's tax allowance on the assumption that tax deductions were taken on the basis of straight-line depreciation. And we would require B to accumulate in a deferred account the tax reducing effects of its excess deductions so that they will be available to reduce its rate base now and its tax allowance later.

What then should we do in setting rates for A? According to Charlottesville, we should flow the consolidated tax savings through to A's ratepayers. This we think is simply wrong. The tax savings produced by B's excess deductions belong to B's future ratepayers, not A's current ratepayers. After all, it is B's future ratepayers who will pay the expense associated with the deductions. So here there should be no flow-through of the consolidated

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[55] Charlottesville moves that all evidence concerning normalization be struck from the record. Charlottesville contends that any consideration of the impact the Commission's normalization policy may have on the proper policy to follow with respect to consolidated taxes is beyond the scope of the Court's mandate remanding this case to us. We disagree. We do not think we are so constrained. *See S.E.C. v. Chenery Corp.*, 332 U.S. 194 (1947). Accordingly, the motion is denied.

tax savings to A's ratepayers.[56] Hence to follow Charlottesville's method we would have to exclude B's losses from consideration.

Though this is a hypothetical, it is by no means atypical. This case presents several examples. During the test year Columbia LNG was building a terminal to receive and regasify imported liquefied natural gas. This portion of the company's business reported a tax loss because of typical timing difference expenses. That is, the company's construction expenses, such as interest during construction, were deducted for tax purposes.[57] But for ratemaking purposes these expenses were capitalized. The company will recover them over the life of plant through depreciation expense. Hence the deductions should be used to reduce the rates of that operation's future customers.

And that is what we did. When we set rates for this operation, we required that the tax reducing effects of the deductions for the construction period be accumulated in a deferred account so that they could be used to reduce the tax allowance over the life of the plant.[58]

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[56] Note that since the hypothetical concerns 1982, B's depreciation expense deduction for tax purposes would be governed by the new Accelerated Cost Recovery System, which was enacted by Congress in the Economic Recovery Tax Act of 1981. Pub. L. No. 97-34, §§ 201-209, 95 Stat. (1981). If the utility is to use that method, its rates must be set on a normalized basis. Having done that for B, a question has been raised whether flowing the savings through to A's ratepayers would violate the statutory mandate. *See* Exh. 1 at 5; Exh. 11 at 21. For a contrary view, see Exh. 13 at 54-55; Tr. 534.

Without a definitive ruling from the Internal Revenue Service, we cannot resolve this question.

[57] Exh. 3. These timing difference expenses were the only source of the loss. Thus, if this operation's expenses were reported on the tax return in the same way that we recognized expenses in the cost of service, the LNG operation would not have reported a tax loss.

[58] *See Columbia Gas Transmission Corporation*, 8 FERC ¶ 62,005 (1979).

The company also began to operate a synthetic natural gas plant in the test year. This operation also reported a tax loss solely because of timing difference expenses.[59] Though we have no jurisdiction over this operation and its rates, the company and customers have agreed to price the synthetic gas on a cost of service basis. So the company capitalized its construction expenditures, charged depreciation at a straight-line rate, and accumulated the tax effects related to those expenditures and its excess depreciation deductions in a deferred tax account.[60]

These results are proper. The rates Columbia LNG charges flow the tax benefits created by its deductions through to the ratepayers who pay the associated expenses when those expenses are recognized in rates.[61]

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[59] Exh. 3.

[60] Exh. 1 at 5-6.

[61] It might be argued that whatever the merits of normalization in other cases, it is irrelevant here. This is so, it might be argued, because the ratepayers of Columbia LNG are the ratepayers of the pipeline. Since that is so, normalization is not needed to preserve the tax benefits for ratepayers. The tax benefits should therefore be flowed through to the pipelines' ratepayers immediately.

We reject this argument. Columbia LNG's rates are normalized. It would be extremly hard to undo that now.

But even if those decisions had not already been made, we would reject this argument. The liquefied natural gas the company produces is sold to Columbia Gas Transmission and flows to all the ratepayers of the pipeline. But still the ratepayers are not identical. The ratepayers who should receive the tax benefits are those customers who will pay the expenses over the life of the plant. But under Charlotteville's method the ratepayers who receive the benefits are the ratepayers of 1976. Those two groups of ratepayers can never be exactly the same. So Charlottesville's method would create an intergenerational subsidy.

The situation is slightly different with respect to the synthetic gas this company produces. This gas is sold directly to customers of Columbia Gas Transmission. The pipeline performs only a transmission function. Tr. 390. Not all of the pipeline's customers de-

Hence, if we were to follow Charlottesville's method, we would have to exclude from consideration Columbia LNG's losses. To do otherwise would result in the tax savings being flowed through twice.[62] There are many similar cases.[63]

This does not end the significance of normalization, however. Normalization is simply a method of allocating tax deductions over time. It tells us when a tax deduction should be recognized for ratemaking purposes. So before we could even apply Charlottesville's method, we would have to normalize the timing differences shown on the group's consolidated return and eliminate the losses those differences create, whether the losses be reported by a company subject to our rate regulation or not.

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cided to purchase synthetic gas. Exh. 15 at 18. So Charlottesville's method would not only create an intergenerational subsidy here but would also result in the synthetic gas customers subsidizing the pipeline's customers who did not purchase synthetic gas.

[62] Conceivably, we could flow the tax savings created by Columbia LNG's deductions through to the pipeline's ratepayers and still normalize Columbia LNG's rates. To do this, however, we would need to establish a mechanism whereby the pipelines would repay Columbia LNG for the use of its losses as the expenses are recognized in Columbia LNG's rates. This we decline to do. Setting up the required accounting would be complicated. And doing so would cause the pipelines' rates to fluctuate on the basis of events having nothing to do with their own operations.

[63] Many of the cases involve a group of corporations that form a partnership to build a pipeline. The deductions for construction expenditures are used by the partners to reduce their taxes. We ignore the partners' use of the deductions and require the project to accumulate the tax benefits in a deferred tax account as if it were a separate corporation. *See e.g., Trailblazer Pipeline Company*, Initial Decision, 15 FERC ¶ 63,046, at p. 65,175 (1981), *aff'd*, Opinion No. 138, 18 FERC ¶ 61,244 (1982). If we did not do this, the tax benefits would be lost not only to the customers of the project but also, because some of the partners are not regulated, to any group of customers.

Charlottesville takes a different view. It argues that we should follow the Commission's traditional method of using the tax losses that appear on the consolidated return.[64]

This, however, was not the Commission's traditional policy. The question was decided long ago in the *Cities Service* case.

In that case the Cities Service group deducted depreciation expense at an accelerated rate on its consolidated tax return. The Commission's policy at that time was to normalize those deductions.[65] Following that policy the Commission eliminated the timing differences caused by the group's use of accelerated depreciation.[66] We think this was correct. As with any other item to be included in the cost of service, we must allocate the item to the proper time period before we allocate the items among groups. Normalization performs that task for tax deductions.

At the time this case was filed the Commission did not require that all timing differences be normalized. So under the Commission's holding in *Cities Service* some timing differences would remain. What is significant to us in adopting a policy for dealing with consolidated taxes, though, is that we now do require that all timing differences be normalized.[67] In the future all timing dif-

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[64] Charlottesville, of course, recognizes that the pipelines' tax allowances must be normalized to eliminate the timing differences reported by those companies. Thus, Charlottesville has added the pipelines' deferred taxes to the pipelines' allocable share of the consolidated tax liability. *See* Exh. 22B. The question here is whether the same should be done for the other members of the Columbia group.

[65] Order No. 171, 13 FPC 968 (1954).

[66] *See* 30 FPC at 166.

[67] *See* Order No. 144, *Tax Normalization for Certain Items Reflecting Timing Differences in the Recognition of Expenses or Revenues for Ratemaking and Income Tax Purposes*, *supra* n. 14; *see also* Order No. 404, *Calculation of Taxes for Property of Public Utilities, Licensees and Natural Gas Companies Constructed or*

ferences will be eliminated. Doing that will eliminate most, if not all, the losses shown on the consolidated return. That is true of the development companies here,[68] and also true of the losses reported by the members with whom Southern Natural Gas Company joins in filing a consolidated return.[69]

Thus, we are left with the following situation. To make Charlottesville's method responsive to changes that have occurred since the method was formulated over a quarter of a century ago and to therefore make it reasonable, we would have to make exceptions for non-recurring losses, losses incurred in unrelated activities, losses caused by timing differences, and losses incurred by a regulated company. That pretty much covers the field. What is left are losses that are permanent, not caused by timing differences, and that are incurred in an activity related to the pipeline's operations but that is not itself regulated. There are not many losses like that. The only example we have here is the parent's loss. The tax savings produced by that loss are flowed through to ratepayers by our stand-alone method.

Acquired after January 1, 1970, 43 FPC 740, *reh. denied*, Order No. 404-A, 44 FPC 16 (1970), *aff'd sub nom., Memphis Light, Gas & Water Division v. F.P.C.*, 462 F.2d 853 (D.C. Cir.), *cert. denied*, 409 U.S. 941 (1972); *Texas Gas Transmission Corporation*, Opinion No. 578, 43 FPC 824, *reh. denied*, Opinion No. 578-A, 44 FPC 140 (1970), *aff'd, Memphis Light, Gas & Water Division v. F.P.C.*, 500 F.2d 798 (D.C. Cir. 1974).

[68] These companies reported tax losses because they could deduct intangible drilling cost and construction expenditures that are capitalized for ratemaking purposes or because they deducted depreciation at an accelerated rate. When those timing differences are eliminated, the development companies did not have losses in the test year. *See* Exh. 2, Schedule 2. The timing differences of these companies are explained in considerable detail in Exh. 1 at 2-6.

[69] *See Southern Natural Gas Company*, Opinion No. 174, 23 FERC ¶ 61,397 (June 22, 1983).

So our stand-alone method reaches much the same result that would be reached by a proper application of Charlottesville's method.[70] But our stand-alone policy does that quite simply. It requires the answer to only one question: have the expenses that generated the tax deduction been included in the cost of service? That question can be answered readily by examining the cost of service. Charlottesville's method, however, requires the answer to many questions. The answers to those questions are not readily available. In some instances they can only be answered after a detailed examination of the business activities or accounts of companies that are not before us or that might not even be regulated by us. The time needed to answer these questions is unwarranted. Only one element of the cost of service is at stake. And there is another method at hand that is easily applied yet produces just and reasonable results—the stand-alone method. Hence we adhere to that method here.

VIII.

Charlottesville and the Public Service Commission of the State of New York advance a number of arguments against our stand-alone policy.[71] Most of these arguments have been addressed previously. But two arguments warrant further comment.

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[70] To be sure, there might be some differences. But we expect them to be small.

[71] Charlottesville also advances one policy argument in favor of its position. Charlottesville points out that the Columbia pipelines have a "market ordering" problem. By this Charlottesville means that the price the pipelines charge for gas is too high when compared to alternative fuels. Charlottesville argues that as a step towards solving this problem we should flow the consolidated tax savings through to ratepayers in order to lower the delivered price of gas.

Little time need be spent on this argument. That the Columbia pipelines, like many other pipelines, face stiff competition from alternative fuels is obvious. The causes for this are numerous and

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Both Charlottesville and the New York Public Service Commission contend that our stand-alone method is not supportable on the facts of this case. Though the parties express this contention somewhat differently, their point comes down to essentially this: "In instances where the jurisdictional ratepayers of a pipeline are fully insulated from the risks and increased costs associated with the investment activities of non-jurisdictional companies, . . . there may be some basis for reducing the ratepayers' share of the consolidated tax savings generated solely by such non-jurisdictional investments. The situation of the Columbia system, however, is not one of those instances." [72] That is so, the parties contend, because the activities of the pipelines' sister companies, especially the development companies, have imposed numerous burdens on the pipelines' ratepayers. Accordingly, the parties argue that in fairness the tax benefits created by the pipelines' sister companies ought to be shared with the ratepayers.

We disagree. To be sure, we agree with the principle that benefits should follow burdens. That is implicit in our stand-alone policy. What we disagree with is the parties' application of that principle. The task we have before us is to allocate the tax reducing benefits created by the system's deductions to the system's members. That must be done on the basis of some factor that is reason-

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far-reaching. They include management decisions as well as the statutory basis for pricing natural gas at the well-head and changes in the world-wide demand and supply of oil. If the problems are to be solved, they must be solved through measures that address the causes directly and in a comprehensive way. They will not be solved by making *ad hoc* adjustments to the tax allowance, which is a minor part of the cost of transporting gas, which is itself a minor part of the cost of gas sold to consumers.

[72] Brief for the Public Service Commission of the State of New York at 7. *See also* Brief for Charlottesville at 48.

ably closely related to the benefits to be allocated. But the burdens Charlottesville and New York point to (to the extent they are burdens at all) are simply too far removed from the tax benefits to justify allocating the benefits to the ratepayers.

For example, it is argued that the ratepayers are burdened because the pipelines' internally generated funds are used to finance the system's gas supply efforts. Internally generated funds consist of net income (or profits), depreciation, and deferred income taxes. Since a pipeline would not have these funds but for the revenue provided by the ratepayers, the ratepayers can be said to be bearing a burden here. But this is not a burden imposed by the system's gas development activities. Pipelines are not eleemosynary institutions. Their shareholders are entitled to a return on, and a return of, their capital. Pipelines are also entitled to the use of the money ratepayers have paid for taxes that have not yet been paid to the government. The ratepayers have paid no more in rates because of the gas supply efforts. Moreover, what the pipelines' shareholders do with this cash is largely their own business. They may reinvest it in the pipelines or they may invest it in other business ventures. So we do not see how the particular investment decisions the pipelines' shareholders have made, namely, to invest a large part of the cash they derive from the pipelines in gas supply efforts, justify allocating any of the tax benefits created by those efforts to the ratepayers.[73]

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[73] Charlottesville and New York advance a somewhat similar argument concerning taxable income. They argue that because the taxable income generated by the pipelines is needed to give value to the tax losses of the gas supply companies, the pipelines ratepayers should receive the tax savings. But, as with the pipelines' internally generated funds, this is not a burden the system's gas supply companies have imposed on the ratepayers. The pipelines' rates are no higher than they would be if the taxable income generated by the pipelines were not used to give value to the tax losses.

We reach the same conclusion with respect to the argument that because the pipelines are "funneling" hypothetical taxes to the gas supply companies, the ratepayers have been burdened.[74] While the ratepayers are paying a tax allowance and are to that extent burdened, this is not a burden imposed by the gas supply companies. The tax allowances reflect the costs of providing service. Nothing has been added to the tax allowances to help finance the gas supply companies.[75] And what the pipelines do with the revenue they receive for the service they provide is, again, largely their own business.

Other burdens mentioned are more significant. At least here the parties contend that the pipelines' rates are higher because of the system's gas supply efforts. There is some merit to the points the parties make. But there is not enough to justify allocating any of the tax benefits to the ratepayers.

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[74] The "funneling" takes place pursuant to an order of the Securities and Exchange Commission exempting the pipelines from the SEC's rule for allocating the consolidated tax liability, 17 C.F.R. § 250.45(b)(6) (1977). Following this order the consolidated tax liability is allocated to the members' of the Columbia group for financial reporting purposes in a way that three of the gas supply companies are given credit for the tax savings produced by their tax losses. *See* Exh. 5 at 13. What this means is that the amounts the pipelines pay to their parent to help discharge the consolidated tax liability do not reflect any reduction for the tax savings producted by the gas supply companies' losses. Consequently, the parent pays a part of these amounts to the Internal Revenue Service to discharge the tax liability and the remainder to the gas supply companies. Tr. 155.

[75] To be sure, when this case was first here, the Commission held that the tax allowance should be increased to spur additional gas exploration and development. But we place no reliance on that rationale. *See supra* notes 8 & 53. Equally immaterial to us is what the pipelines forward to their parent pursuant to the SEC's allocation rules and orders. That would occur no matter how we treated the consolidated tax liability for ratemaking purposes.

It is pointed out that one of the pipelines, Columbia Gas Transmission, made advance payments to one of the gas supply companies, Columbia Gas Development.[76] Because ratepayers pay the pipeline a return on these advances, ratepayers are here unquestionably bearing a burden.

The primary reason we do not find this to be sufficient is that advance payments did not create any tax benefits for either the pipeline or the gas supply company. So there is no relationship between this burden and the tax benefits to be allocated. We do not see how this burden justifies allocating any of the tax benefits to the pipelines, let alone the tax benefits created by loss companies that did not receive advance payments. Moreover, the burden imposed here is balanced by its own benefit—the prospect of future gas supplies.

Charlottesville and New York also point out that in setting the pipelines' rates of return we have used the parent's capitalization. The parties contend that by doing so we have inflated the pipelines' rates of return and forced ratepayers to finance the system's gas supply efforts. This argument is without merit.

The reason we used the parent's capitalization and cost of capital are fairly obvious. The pipelines issue bonds and common stock to their parent. They issue no securities to the public. So the pipelines' capital structure and cost of capital can be manipulated by the parent "to maximize the profits of the integrated corporate enter-

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[76] Exh. 13 at 25. Charlottesville's witness listed advance payments by both pipelines to all producers. Exh. 14, Schedule 12. These amounts are quite large. Columbia's evidence reveals, however, that only Columbia Gas Transmission made advance payments to an affiliate. These advances are quite small. At the end of the test year, 1974, the outstanding advances totalled only about $3,000,000. Exh. 15 at 13-15; Exh. 17.

prise and maximize the benefits to the parent company's stockholders." [77]

Consequently, to avoid setting rates on the basis of such contrived facts, we must use either the parent's capital structure and costs or hypotheticals.[78] With the Columbia pipelines we have traditionally used, as here, the parent's capital structure and costs.[79]

Using the parent's capitalization solves one problem. But it may create others. Though the use of parent's capital structure and capital costs presupposes that the parent's risks are essentially comparable to those of the pipeline, its risks may not be exactly comparable.[80] Because of investments in other companies, the parent may have more equity than the pipeline would have, a higher cost of debt, or a higher cost of equity. Charlottesville and New York contend that this is so here. They make two points.

First, they argue that the parent's cost of debt has been increased by financing the system's gas supply operations. This is so because much of the system's financing during the relevant period of time was to raise capital for the gas supply companies. The debt raised during this time was more expensive than the debt the parent had previously issued. So the parent's embedded debt costs were raised, and accordingly, so were the pipelines' rates of return.[81]

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[77] *Kentucky West Virginia Gas Company*, Opinion No. 7, 2 FERC ¶ 61,139, at p. 61,326, *reh. denied*, 3 FERC ¶ 61,225 (1978).

[78] *Id.*

[79] *Manufacturers Light and Heat Company*, Opinion No. 583, 44 FPC 314, 326, *reh. denied*, 44 FPC 1138 (1970); *Manufacturers Light and Heat Company*, 23 FPC 446, 448 (1960).

Charlottesville's witness thought this was preferable to using hypotheticals. Exh. 13 at 21.

[80] *See Kentucky West Virginia Gas Company*, 2 FERC at p. 61,326.

[81] Exh. 13 at 22-24.

Second, they argue that the parent's cost of equity has been increased. This is so, they say, because the stock market views gas exploration operations as riskier than pipeline operations. This perception has entered into the market's calculation of Columbia's stock and would be reflected in a higher cost of equity. So the pipelines' rates of return reflect a "risk premium" for the system's exploration and development activities.[82]

The evidence shows that the system's exploration and development activities have had some impact on the cost of debt used in setting the pipelines' rates of return, though less than Charlottesville claims and far less than the tax benefits at issue.[83] This evidence might justify, on purely equitable grounds, some sharing of the consoli-

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[82] *Id.* at 21-22.

[83] Charlottesville says that the cost of debt was raised from 6.60% to 7.29% and that the pipelines' revenue requirement was increased by $5.2 million. Exh. 13 at 23-24; Exh. 14, Schedules 4-8.

Columbia does not dispute that the pipelines' revenue requirements have been increased. But it argues that the increase is only $2.6 million. Exh. 15 at 8-10; Exh. 16. We think Columbia is correct.

We find no evidence that the system's gas supply efforts have caused investors to add a risk premium to Columbia's stock. While it is no doubt true that investors view gas exploration activities as riskier than the pipeline business, that is not enough to establish the existence of a risk premium. An investor's required return is based on the consolidated earnings power of the Columbia system. That system is large and operates in all the major areas of the gas business. Hence before we could conclude that the system's gas supply activities have raised the investor's required return, we would need evidence on the system's other business activities and how those activities interact with the gas supply efforts. But no such evidence was offered. Moreover, the only evidence in the record that remotely bears on this question is the credit rating for the system. Throughout the 1970's Columbia maintained an A credit rating. Exh. 15 at 7. This suggests to us that investors' perceptions of the riskiness of the system were not greatly affected by the existence of the gas supply companies.

dated tax savings if there were no other way to protect the ratepayers from this increased cost of capital.

But this is not the case.

Our stand-alone policy applies not only to the determination of a utility's tax allowance but also to the determination of the utility's rate of return.[84] Hence, when we use the parent's capital structure and costs, adjustments, where necessary, can be made to both elements to insure that the return reflects only the risks and costs of providing the specific service at issue. And where the question has been raised the Commission has done so. It has eliminated equity from the capital structure when the equity was used to finance non-utility business or operations that were separately regulated by the Commission;[85] it has eliminated the risks imposed on the system by operations other than the pipeline;[86] and it has endorsed in principle excluding from the rate of return the cost of debt that was not used to finance the pipeline business.[87]

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[84] *Kentucky West Virginia Gas Company*, 2 FERC at p. 61,325.

[85] *El Paso Natural Gas Company*, 44 FPC at 77; *Southern Natural Gas Company*, Opinion No. 585, 44 FPC 567, 571-73 (1970).

[86] *See e.g., Arkansas Louisiana Gas Company*, Opinion No. 71, 10 FERC ¶ 61,027, at p. 61,046, 10 FERC ¶ 62,195 (1979), *rev'd on other grounds*, 654 F.2d 435 (5th Cir. 1981); *Consolidated Gas Supply Corporation*, Opinion No. 70, 10 FERC ¶ 61,029, at p. 61,053 *reh. denied*, 10 FERC ¶ 62,224 (1979), *aff'd* 653 F.2d 129 (4th Cir. 1981); *Natural Fuel Gas Supply Corporation*, Initial Decision, 5 FERC ¶ 63,018, at pp. 65,143-45 (1978), *aff'd*, Opinion No. 58, 8 FERC ¶ 61,135 (1979); *Pacific Gas Transmission Company*, 43 FPC at 842-43.

[87] *Florida Gas Transmission Company*, Opinion No. 561, 42 FPC 74, 79, *reh. denied*, 42 FPC 649 (1969), *rev'd on other grounds sub nom. Sun Oil Co. v. F.P.C.*, 445 F.2d 764 (D.C. Cir. 1971) (cost of debt should in theory be lowered, but no adjustment made because the difference was trivial).

So nothing prevented the parties from raising their concerns that the return was too high when that issue was presented to the Commission for decision. But they did not. Instead, they settled.[88] Hence what the parties' argument here amounts to is a plea that we use consolidated tax savings to relieve them of a bargain with which they are no longer happy. This we decline to do. The plea is too late.

B.

Charlottesville contends that our stand-alone method consistently produces tax allowances for the pipelines far larger than the pipelines' "actual tax responsibility." Charlottesville supports this argument with a table comparing the pipelines' stand-alone tax allowances with various amounts reported to the Internal Revenue Service on the group's consolidated returns.[89] This table shows, for example, that the rates in this docket, which were in effect for most of 1976, assumed that the pipelines' tax costs totalled $78.4 million. Charlottesville says that the pipelines' share of the group's actual tax liability was $60.6 million before investment tax credits and $52.8 million after investment tax credits. Moreover, Charlottesville says, in some years the pipelines' stand-alone tax allowances exceed the actual tax liability of the entire group. Charlottesville therefore argues that our stand-alone policy violates the statutory mandate that "requires that ratepayers reimburse a regulated pipeline only for actual costs, including federal income taxes" and is thus unlawful.[90]

We disagree. We do so not because we disagree with the principle that only actual costs should be included in the cost of service. Everything we have heretofore said

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[88] *See* the order issued in these dockets on September 13, 1976. 56 FPC 1651.

[89] *See* Table II on page 28 of Charlottesville's Initial Brief.

[90] Initial Brief for Charlottesville at 31.

in this Opinion shows that we are in complete agreement with that principle. Rather, we do so because we cannot agree that the amounts reported to the Internal Revenue Service represent the actual tax costs the pipelines incur in providing service.

There are a number of reasons the pipelines' tax allowances exceed what Charlottesville says is the pipelines' "actual tax responsibility" and even exceed the group's actual tax liability as shown on the group's tax return. Most of these involve policies and ratemaking methodologies that have nothing to do with the treatment of the consolidated tax savings. These policies and methods are not in dispute. So even if we were to follow Charlottesville on the consolidated tax issue here, we would not use the "actual tax responsibility" it has calculated as the pipelines' tax allowances.[91]

Nevertheless, our stand-alone policy produces tax allowances for the pipelines that will be somewhat larger than the amounts Charlottesville calculates as their "actual tax responsibility." This difference stems from the method used to allocate the consolidated tax liability. Charlottesville has allocated to the pipelines a portion of the consolidated tax liability, and therefore a portion of all the tax savings, according to the method it advocates here.[92] The stand-alone tax allowance allocates only a portion of the tax savings generated by the parent's excess interest deductions.

Charlottesville's comparisons and argument on this point suggest that the portions of the consolidated tax liability it has allocated to the pipelines reflect the pipelines' actual tax liabilities, the taxes they actually pay to the Internal Revenue Service. There is some merit to this

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[91] The basic differences are described in the pipelines' Reply Brief at 4, 9-10.

[92] *See supra* p. 15.

suggestion even though, as we previously said, no amount can be identified from the face of the return as the actual tax liability of a member of the consolidated group. The reason is that the Internal Revenue Code and the regulations require the group to allocate the consolidated tax liability to the members.[93] One of the methods permitted is identical to the method Charlottesville uses.[94] And this is the method the Columbia group uses to allocate its consolidated tax liability for tax purposes.[95]

There are, however, two reasons we cannot treat the allocation used for tax purposes as the pipelines' actual tax costs for cost of service purposes. First, the Code and regulations require an allocation of the consolidated tax liability to determine each member's "earnings and profits."[96] This, in turn, is necessary to determine whether a distribution is a taxable dividend or a tax-free return of capital.[97] So the allocation is required to administer the revenue laws. It has no other effect. It does not determine what each member pays to the parent to help discharge the liability.[98] Nor does the allocation attempt to ascertain the tax costs of a member for ratemaking, or any other, purpose.[99] Hence, we think the

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[93] I.R.C. § 1552(a); 26 C.F.R. §§ 1.1502-33(d) and 1.1552-1(a).

[94] I.R.C. § 1552(a)(1); 26 C.F.R. § 1.1552-1(a)(1)(ii).

[95] Tr. 165.

[96] I.R.C. § 1552(a); 26 C.F.R. §§ 1.1502-33(d) and 1.1552-1(a).

[97] I.R.C. § 316(a).

[98] That is determined either by an agreement among the members of the group or, where the group is a public utility holding company like Columbia, by the rules and orders of the Securities and Exchange Commission. *See supra* n. 74.

[99] *See* Technical Information Release 878, 1967 Stand. Fed. Tax Rep., ¶ 6396, where it is said:

> The alternative methods of allocating the Federal income tax liability provided under section 1552 of the Code, as well as the

allocation a consolidated group reports for tax purposes is simply too far removed from the issues before us to warrant its adoption as the allocation to be used for cost of service purposes.

Secondly, the allocation method used by the Columbia group is only one of many the Code and regulations permit a group to use.[100] The amounts allocated to the members under these various methods can be quite different. For example, one method allocates to the loss members the tax reducing benefits attributable to the use of their losses on the consolidated return.[101] Put differently, this method produces an allocation of the consolidated tax liability almost exactly opposite the one produced by the method Columbia uses.

The important thing about these alternative methods of allocating the consolidated tax liability is that they are elective. A group can choose any one of them.[102] Hence to treat the amounts allocated to members for tax purposes as the member's actual tax costs for ratemaking purposes would mean the tax allowance of a regulated member of an affiliated group would be determined by the election of the group. Thus, the rates charged to ratepayers of different companies could vary considerably because of the way the members of the groups have chosen to adjust their earnings and profits. As a policy matter, we think that is unacceptable. The differences in rates would not be based on differences in the cost of pro-

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methods provided under the proposed regulations [codified at 26 C.F.R. § 1.1502-33] may be elected even though the Federal income tax liability may be allocated in a different manner for purposes other than the Internal Revenue Code, which are not intended to be affected.

[100] *See* I.R.C. § 1552(a)(2)-(4) and 26 C.F.R. §§ 1.1502-33(d)(2)(i)-(iii) and 1.1552-1(a)(2)-(4).

[101] *See* 26 C.F.R. § 1.1502-33(d)(2)(ii).

[102] *See* 26 C.F.R. §§ 1.1552-1(c)(1) and 1.1502-33(d)(3).

viding service.[103] Accordingly, we see no alternative but to disregard the allocation the Columbia group uses for tax purposes and make our determination of the amount of the consolidated tax liability that should be allocated to the pipelines.

IX.

The other issue before us concerns the tax savings created by the parent's loss. This issue involves no question of policy. Everyone agrees that under our stand-alone method, these tax savings must be shared with the pipelines' ratepayers. Instead, the question here is the technical—though complicated—one of whether those savings have been used to reduce the pipelines' tax allowances.

These are the facts:

(1) The subsidiaries of the Columbia group issue no securities to the public. The parent secures all the capital for the system by issuing debt and equity securities to the public. The subsidiaries obtain their capital by issuing debt and equity to the parent.

(2) So the parent receives dividends and interest from its subsidiaries. And it pays interest to its bondholders.

(3) In calculating the consolidated taxable income on the consolidated return the parent's dividend income is

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[103] For example, the Southern Natural Gas Company has, since 1967, joined with its parent, Sonat Inc., and its affiliates in filing a consolidated tax return. For tax purposes the Sonat group allocates its consolidated tax liability in a way that the members' reporting a tax loss are credited with the "tax savings"—just the opposite of the method the Columbia group uses. *See* Exh. 1(j) at 4, *Southern Natural Gas Company*, Opinion No. 174, 23 FERC ¶ 61,397. Thus, if we were to follow the allocation method the group uses for tax purposes, the ratepayers of the Columbia pipelines would receive the tax saving the group derives from filing a consolidated return but the ratepayers of the Southern pipeline would not. We can perceive no justification for that.

excluded.[104] The parent therefore reports only its interest income and interest expense. Because the parent's interest expense is greater than its interest income, the parent reports a tax loss. This loss is used to reduce the taxable incomes of other members of the group. Thus, the parent's excess interest expense deductions create a tax savings.

(4) There are two reasons the parent's interest expense is greater than its interest income. One is that the interest rate on the bonds the parent issues to the public is slightly higher than the interest rate on the bonds the subsidiaries have issued to the parent. This difference in interest rates is minimal.[105] It accounts for only a small portion of the difference between the parent's interest expense and interest income.[106] The other reason for the difference is that the parent has more debt in its capital structure than do the subsidiaries. In 1974 the capital structures of the parent and the subsidiaries were as follows:[107]

	Parent	*All Subsidiaries*
Debt	57.8%	48%
Preferred Stock	2.1%	—
Common Equity	40.1%	52%
	100.0%	100%

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[104] 26 C.F.R. § 1.1502-14(a).

[105] What happens is this: The parent will, for example, issue 30 year bonds to the public paying a coupon rate of 9.83%. When the parent lends money to one of its subsidiaries, the maturity and interest rates on the subsidiary's bonds are tied to those of the parent's most recent borrowing. The interest rate, however, is rounded down to the next lower 1/10th of one percent. Thus, the subsidiary would issue to the parent 30 year bonds with a coupon rate of 9.80%. *See* Exh. 5 at 7.

[106] *Id.* at 8.

[107] Exh. 8, Schedule 2.

(5) In settling most other issues in this case the parties agreed to use the parent's capital structure and cost of capital to establish the pipelines' rates of return. Thus, the rate of return is based on the parent's, not the pipelines', interest expense. Because this is so, our stand-alone policy requires that the tax savings created by the parent's excess interest deductions be used to reduce the pipelines' tax allowances.

(6) In a normal case the tax allowance is simply the tax factor derived from statutory tax rate applied to the tax base. The tax base is derived, essentially, by multiplying the rate base by the overall rate of return and then subtracting the company's interest expense used in determining the return.[108] In calculating their tax allowances the pipelines followed this method exactly. The only point worth noting is that the interest expense the pipelines deducted was their parent's interest expense since the overall return was based on the parent's capital structure and costs.

None of these points is in dispute. What is in dispute is the significance of using the parent's interest expense as the interest deduction in calculating their tax allowances. The pipelines contend that by using the parent's interest expense they have flowed the savings created by the parent's loss through to the ratepayers. Charlottesville contends that the pipelines are wrong. Using the parent's interest expense, Charlottesville argues, does not flow the tax savings through to ratepayers. To do that, Charlottesville says, an effective tax rate, not the statutory rate, must be used. The pipelines contend that using an effective tax rate would result in giving their ratepayers the tax savings twice. We hold that the pipelines are correct.

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[108] For a fuller description of how the tax base is calculated, see *supra* p. 11.

Charlottesville argues that the pipelines are wrong because by using the parent's interest expense as a deduction the pipelines have done nothing but follow the Commission policy mandating interest synchronization, which is simply the fancy name for the idea that the interest expense taken as a deduction in calculating the tax allowance should be the same as the interest expense used in calculating the return.[109] Charlottesville contends that interest synchronization does not flow the tax savings through to ratepayers. Charlottesville's reasoning here appears to be that because interest synchronization would be used even if there were no consolidated tax savings to be flowed through, the use of that policy has no effect on the tax savings.

We agree with Charlottesville that all the pipelines have done is to follow our policy requiring interest synchronization. We also agree that interest synchronization would be used whether or not there is a tax savings to be shared with ratepayers. But to say this does not answer the question, which is, what is the effect of using interest synchronization here?

That effect we think is obvious. As we have discussed previously, the task before us is to allocate deductions among members of the group. In this case the pipelines' ratepayers are charged with the responsibility of paying the parent's interest expense. Therefore, the parent's interest expense deduction should be allocated to the pipelines and used to reduce their tax allowances. This is just what the pipelines have done by deducting the same interest expense in calculating their tax allowances.

There is another reason the pipelines are correct. The effect of using the parent's capital structure and costs in

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[109] *Sierra Pacific Power Company*, Opinion No. 730, 53 FPC 1975, 1806-7 (1975), states the general rule. But there can be exceptions. *See e.g., East Tennessee Natural Gas Company*, Opinion No. 106, 13 FERC ¶ 61,227 (1980).

setting the return is to treat the pipelines and their parent as one business. Viewed in this way the pipelines and parent have income (what the pipelines receive from ratepayers) and an interest deduction (what the parent pays its bondholders). Their tax allowances should be based on those elements. And that is what the pipelines have done by deducting the parent's interest. The effect of filing a consolidated tax return is also to treat the pipelines and their parent as a "single entity." [110] The consolidated tax liability is therefore based on this entity's dealings with outsiders—ratepayers and bondholders. So the tax allowance is based on the same elements as is the tax liability on the consolidated return. Accordingly, the tax allowance will equal the tax liability that would be produced on the consolidated return by deducting the parent's interest expense against the pipelines' income. Since the consolidated tax liability reflects the tax savings, the tax allowance will, too.

This point can be demonstrated. Since the question is really one of arithmetic, we, like the parties, will do so by means of an example using simple numbers.

Suppose that P Company (P) sells $10,000 of securities to the public: $6,000 of bonds paying 10% and $4,000 of common stock on which P will pay 12%. P does not carry on any business. Instead, it forms a subsidiary, S Company (S), to transport natural gas. P invests all of its capital in S. For its $10,000 P receives $5,000 in bonds paying 8% and $5,000 of common stock on which S will pay 12%. S has no other capital. With its $10,000 S builds a pipeline.

Suppose further that at the beginning of the year S puts into effect rates that yield revenue of $1,560. At the end of the year S and P file a consolidated tax return. A customer then complains to the Federal Energy Regulatory Commission that S's rates are excessive.

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[110] *See supra* p. 2.

To justify its rates S files a rate of return study and a cost of service. The rate of return study is based on P's capital structure and cost of capital. Those are as follows:

	Ratio	*Cost*	*Weighted Cost*
Debt	60%	10%	6.0%
Equity	40%	12%	4.8%
	100%		10.8%

Using this capitalization, S's cost of service study shows return, tax allowance, and revenue requirement as follows:

Debt	$ 600
Equity	480
Total Return	$1080
Less: Interest	(600)
Tax Base	$ 480
Tax Allowance (at 50%)[111]	$ 480
Revenue Requirement	$1560

Proof:

Gross Income	$1560
Less: Interest	(600)
Taxable Income	$ 960
Tax (at 50%)	$ 480

The customer does not contend that using the parent's capital structure and cost of capital is wrong. What the customer argues is that the tax allowance is too high.

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[111] The tax allowance includes an amount to compensate for the fact that the tax allowance is subject to taxation when received. When the tax rate is 50%, the additional amount is exactly equal to the tax on the tax base. *See supra* p. 11.

This is so, the customer argues, because the tax savings produced by filing a consolidated return are not reflected in the rates. To do that an effective tax rate must be used. S takes the opposite position. It argues that the tax allowance already reflects the tax savings.

If S is correct, the tax allowance should be equal to the consolidated tax liability. That is in fact the case.

The first step in preparing the consolidated return is to calculate the taxable income of each member. S will report gross income of $1,560, which is what is received from ratepayers. From this S will deduct the interest it paid P—its book interest. S's interest expense is $400.[112] Taxable income for S is therefore $1,160.

P received during the year $600 in dividends and $400 in interest from S. But for purposes of calculating taxable income on the consolidated return P's dividend income is excluded. P's gross income is therefore $400. From this P will deduct the interest it paid to its bondholders. That amount is $600. P therefore reports a tax loss of $200.

The calculations of the taxable incomes of S and P would look like this:

S		*P*	
Gross Income:		Gross Income:	
Operations	$1560	Interest from S	$ 400
Deductions:		Deductions:	
Interest to P	(400)	Interest	(600)
Taxable Income	$1160	Taxable Income	$(200)

The next step is to consolidate each member's taxable income. That calculation would look like this:

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[112] S has issued $5,000 of bonds at 8%.

Gross Income:	
S's operations	$1560
P's interest	400
Total	$1960
Deductions:	
S's interest	(400)
P's interest	(600)
Total	(1000)
Consolidated taxable income	$ 960

The tax on the consolidated taxable income is $480—just what the tax allowance included in the cost of service is.[113]

If S and P had filed separate returns, the tax liability S would have incurred on its own taxable income is $580. So the filing of the consolidated return produces a tax savings of $100 ($580-480). Put differently, S had an effective tax rate of 41.4%.[114] But there is no need to reduce S's tax allowance by $100 or to use an effective tax rate. The consolidated tax liability, which is used in the tax allowance, already reflects the effects of using P's interest expense to reduce S's taxable income.

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[113] The calculation of the consolidated tax liability looks a little different from the calculation of the tax allowance. But this difference is without significance. Unlike the calculation of the tax allowance, the consolidated return continues to respect corporate form. Because that is so, there is an intermediate step in calculating the consolidated tax liability. That step is to allow S to report a deduction for the interest of $400 it pays to P and to require P to include its interest income from S. Because those amounts are equal, the intermediate step is a wash. This leaves only income of $1,560, which is offset by $600 of interest expense. The tax allowance is calculated in the same way.

[114] The effective tax rate is derived by dividing the consolidated tax liability of $480 by S's own taxable income, $1160, as shown on the consolidated return.

Of course, the tax savings could be reflected in the tax allowance by using an effective tax. But if that were done, then S's own interest expense, not the parent's, would have to be used as the interest deduction in calculating the tax allowance.[115] This is so because using an effective tax rate or the parent's interest expense reduces the tax allowance by the tax savings. But they do so in different parts of the formula. Hence the one thing that cannot be done is, as Charlottesville would have us do, to deduct the parent's interest expense and use an effective tax rate. To do that would be to flow the tax savings through to ratepayers twice. The company would then not recover its tax costs or earn its allowed return. This can be seen in the following comparison:

	P's Interest/ Statutory Rate	*S's Interest/ Effective Rate*	*P's Interest/ Effective Rate*
Debt	$ 600	$ 600	$ 600
Equity	480	480	480
Return	$1080	$1080	$1080
Less: Interest	(600)	(400)	(600)
Tax Base	$ 480	$ 680	$ 480
Tax Allowance	$ 480[116]	$ 480[117]	$ 339[118]
Revenue Requirement	$1560	$1560	$1419

Charlottesville thinks all this is irrelevant. According to Charlottesville, what is significant is that the parent's cost of debt is higher than the costs the pipelines incur on the debt they have issued to the parent. Since the par-

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[115] This is what the Commission did in the old consolidated tax cases where the parent reported a tax loss because of its interest deduction and an effective tax rate was used. *See supra* p. 17. This was also what the Columbia pipelines did in rate cases prior to the change in the Commission's policy in *Florida Gas*. Tr. 428.

[116] The tax rate is 50%.

[117] The tax rate is the effective tax rate of 41.4%.

[118] *Id.*

ent's cost of debt was used in setting the rate of return for the pipelines, Charlottesville argues that the ratepayers are reimbursing the pipelines for costs not incurred.

It is difficult to know what to make of this argument. It sounds as though Charlottesville's complaint is with the use of the parent's cost of debt in setting the rate of return rather than with the use of the parent's interest expense as a deduction in calculating the tax allowance. But Charlottesville says that this is not its position. Charlottesville recognizes that in settling other parts of the case it has agreed to use the parent's capital structure and costs for the pipelines' return. Charlottesville says that it is not contending that the settlement's rate of return should be changed.[119] Instead, Charlottesville says that its position is that, because the return is inflated, deducting the parent's interest expense does not flow the tax savings through.

This argument is without merit. The issue here is whether the tax savings created by the parent's interest expense have been flowed through by deducting those expenses in calculating the pipelines' tax allowances. To answer that we must look at the tax consequences of our order. Those consequences are unaffected by the interest expense we use in setting the return. Companies do not report income on the basis of what revenues recover their equity return and what recovers their debt costs. Instead, they simply report gross income and deductions. So whether the pipelines' or the parent's cost of debt is used in the setting, the return tells us nothing about the tax consequences. That must be determined by considering the interest expense deductions taken on the consolidated return.[120]

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[119] Tr. 548, 586.

[120] Charlottesville has attempted to prove its argument by comparing the tax base when the pipelines' cost of debt is used in set-

What this argument does tell us, then, is that despite its statements to the contrary, Charlottesville's position is that using the parent's capital structure and costs has inflated the return. Is this so? Nothing in the record shows that a return based on the pipelines' own capital structure and costs would be lower.[121] But even if there were, we could not conclude that the return is inflated. As we have said previously, where a subsidiary issues no

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ting rates and when the parent's cost of debt is used. *See* Exh. 13 at 39-41; Exh. 14, and Schedules 14-15; Exh. 49; *see also* Petitioner's Reply Brief, *City of Charlottesville v. F.E.R.C.*, 661 F.2d 945. This comparison shows that the tax base is the same. This should not be, Charlottesville implies, if deducting the parent's interest expense had the effect the pipelines claim it does.

The problem with this comparison is that it rests on contrived facts. What Charlottesville has done is to substitute the pipelines' cost of debt for the parent's cost of debt in the parent's capital structure. Everything else remains the same, including the equity component. Because the equity component is the basic measure of the tax base, the tax base will of course be the same whether the parent's or the pipelines' cost of debt is used.

But the pipelines' cost of debt cannot be used with the parent's capital structure. A company's cost of debt only has significance in relation to its own indebtedness. Hence, if the pipelines' cost of debt is to be used, then their capital structures should also be used. Tr. 545. When that is done, however, Charlottesville's argument falls apart. The pipelines have more equity than their parent. So the equity return will be higher if the pipelines' capital structure and costs are used. The tax base will accordingly be higher than it would be if the parent's capital structure and costs are used. *See* Exh. 53, Schedule 2.

[121] True, Charlottesville's witness calculated a rate of return based on the pipelines' own capital structure and costs. Exh. 53, Schedule 1. The rate of return so calculated is 9.06% while the rate of return included in the settlement, is 9.49%. But the 9.06% rate of return was not based on a test year estimate of interest expense. It was based on amounts recorded on the pipelines' books. So the return is somewhat understated—by how much we do not know. Moreover, the settlement's rate of return was the product of a settlement. It might not be calculated in exactly the same way as the witness did for the pipelines.

securities to the public, its capital structure and costs should not be used.[122] Those elements have been determined by the parent, not the market. The parent can manipulate those elements for its own advantage. That cannot be permitted. Moreover, in this case the parties, including Charlottesville, have agreed to use the parent's capital structure and costs. That agreement is final. So it is too late to complain now that the return is too high.

The Commission orders:

(A) The refund condition imposed by Article IV-D of the Stipulation and Agreement filed in these dockets on June 8, 1976, as modified by Paragraph B of the Commission's order of September 13, 1976, in these dockets [56 FPC 1651], is terminated.

(B) These dockets are terminated.

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[122] *See supra* pp. 41-42.

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Docket No. RP75-105-003

COLUMBIA GULF TRANSMISSION COMPANY

Docket No. RP75-106-007

COLUMBIA GAS TRANSMISSION CORPORATION

Notice of Denial of Rehearing

(Issued August 22, 1983)

Kenneth F. Plumb, Secretary.

On July 22, 1983, the City of Charlottesville, Virginia applied for rehearing of the Commission's Opinion No. 173, issued in these dockets on June 22, 1983 [23 FERC ¶ 61,396]. The Commission has decided to deny the application pursuant to Section 19(a) of the Natural Gas Act by not acting upon it.

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

GEORGE A. FISHER, Clerk October 18, 1985

RE: No. 83-2059—City of Charlottesville, Virginia v. Federal Energy Regulatory Commission

Dear Counsel:

Enclosed herewith are three (3) copies of the opinion in the above entitled case.

Please note that the judgment has been entered on the same date as the opinion and is for mandate purposes only.

Sincerely,

/s/ Denise C. Thomas
DENISE C. THOMAS
Opinions Clerk

enclosures

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UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

September Term, 1985

No. 83-2059

CITY OF CHARLOTTESVILLE, VIRGINIA

v.

FEDERAL ENERGY REGULATORY COMMISSION

[Filed Jan. 13, 1986]

Before: Robinson, Chief Judge; Wright, Wald; Mikva, Edwards, Ginsburg, Bork, Scalia, Starr, Silberman and Buckley, Circuit Judges, and Gasch *, District Judge, U.S. District Court for the District of Columbia

ORDER

The suggestion for rehearing *en banc* of petitioner City of Charlottesville, Virginia and the memorandum in support thereof have been circulated to the full Court and no member has requested the taking of a vote thereon. Upon consideration of the foregoing, it is

ORDERED, by the Court, that the suggestion is denied.

Per Curiam

FOR THE COURT
GEORGE A. FISHER
Clerk

By: /s/ Robert A. Bonner
ROBERT A. BONNER
Chief Deputy Clerk

Circuit Judge Buckley did not participate in this order.

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* Sitting by designation pursuant to 28 U.S.C. 292(a).